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# Regulatory Capture in the Context of EU Lawmaking

Regulating an industry, regardless of the nature of that industry, is always a delicate exercise. Beyond the technicalities inherent to any particular field of the economic or the business world, the difficulty of regulating an industry comes essentially from a very natural phenomenon of proximity between the business elites which are to be regulated, the relevant political elites and, by extension, regulatory authorities.

This phenomenon, I believe, exists pretty much everywhere in the world and regardless of the industry that needs to be regulated. Elites usually come from similar social and educational backgrounds, they have a natural tendency to get together, to be close to each other, to exchange services, to belong to the same circles and to party together. This should not surprise anyone.

But, saying that this phenomenon of proximity should not be a surprise is not to say that it is neutral, that we should satisfy ourselves with it nor that it does not have consequences. The first consequence, obviously, is that proximity creates complacency and forbearance. The second consequence is that the proximity between the elites in charge of public interest (political and regulatory elites) and the business and economic elites whose job is to develop and promote private interests creates an environment where public interest and private interests tend to be confused.

It has to be said that the problem here is not that private interests should defend themselves and promote the arguments and the regulations that will benefit them: this is normal, this is legitimate, this is to be expected. The problem here is the possible confusion between public interest and private interests: democracy and the rule of law require that elected officials and civil

servants have the conviction that public interest is not equal to the sum of private interests and that they have the understanding, the vision and the courage to take the measures necessary for the public interest even if and when they will hurt some private interests. Do not get me wrong, I am not saying that public authorities should not make all possible efforts not to hurt private interests, they should. I am simply saying here that there exists situations where promoting and defending public interest will require going against some private interests and that public authorities should not be afraid of doing so when necessary.

When it comes to regulating financial services, the universal phenomenon of proximity that I just described is “supported”, if I may use that expression, by Adam Smith’s notion of the



“invisible hand” which has been hijacked by large parts of the financial industry as meaning that if an activity, any activity, makes a profit for someone it is necessarily good for the entire society. We all know that this is not what Adam Smith meant and that in reality he was a strong advocate of a sensible regulation to counter balance the natural hegemonic momentum of private

interests but this is what the public debate kept of his work. We also know that this degenerated version of Adam Smith's *invisible hand* is what led to 20 years of deregulation in financial services with the consequences that we know.

Interestingly, from my years advocating on the ground with Finance Watch, I can assure you that even seven years after the burst of the last financial crisis, the *invisible hand argument* is still widely used: I remember for instance



with a fond memory the honourable Member of the European Parliament who during the public hearing on MiFID, in response to my statement on why high frequency trading was not what European financial markets needed to bring capital to productive use, asked me during the Q&A session: "Please reassure us Mr. Philipponnat, you are not against computers, are you?". By asking that question, that gentle lawmaker was showing his conviction that since high frequency trading is about clever people making good money in financial markets, it is necessarily good for society precisely by the simple virtue of the fact that it generates revenues for high frequency traders.

But understanding regulatory capture in financial services in the context of the European Union also requires to take into account another factor: The

European Union, as we know, is working on building a single market with a single rule book but it is not a homogeneous political zone. In fact, it is composed of 28 Member States who, of course, say they want to cooperate to build the single market but also compete with one another to develop their own domestic markets and defend their national interests. When it comes to financial services, more or less all EU Member States equate defending their national interest with defending the interest of their national champions and their national financial industry against the rest of the world, including against their European competitors. This is where the phenomenon of proximity between business and political elites comes back: at national level, the capture through proximity of political elites and, to a non-negligible extent, of regulatory authorities by private interests exists. And the consequence of this phenomenon is striking: the typical EU lawmaking process in financial regulation over the past 5 years has seen the European Commission propose texts that often did make a difference despite the army of Brussels based lobbyists trying to convince them day after day not to do so, the European Parliament takes up the texts, works on them, debates them and in many cases improves them and the Council almost systematically waters the texts down away from the European public interest in order to make them as close as possible to each time different national interests of different Member States. I could easily illustrate this point on legislations as diverse as European Market Infrastructure Regulation (EMIR), Capital Requirements Directive (CRD 4), Markets in Financial Instruments Directive (MiFID), Money Market Funds, Packaged Retail Investment Products (PRIIPS), Bank Recovery and Resolu-

tion Directive (BRRD), banking union or the recent proposal by the Commission to reform the structure of the EU banking sector, to name but a few. I think, I can affirm that no European Union Member State is exempt from the practice of transforming the private interest of its national financial sector champions into national interest and subsequently influencing the EU lawmaking process through the Council.

Obviously, this is made possible by the fact that the EU is not a politically integrated zone and that its lawmaking process is based on a co-legislation mechanism between the European Parliament and the Council in a context where the Parliament, for all its imperfections, has an EU mandate when the Council acts as the representative of national interests. The dichotomy between the positions of those two institutions is often difficult to reconcile for the better of the European public interest.

Among the many anecdotes that could be told to illustrate this point, the situation that prevailed in January of this year is worth to mention. On 19 December of last year, the Commissioner for internal markets and services Michel Barnier banned his department's staff from holding meetings with bankers in the wake of the then coming proposal to reform the structure of EU banks that was being finalised at the time. The objective was to allow its staff to come up with a proposal that would not be watered down too much by the pressure of banking lobbies. What happened then was quite extraordinary as banking lobbies who had seen the door shut on them came back through the window with the help of a number of national governments that spent an enormous amount of energy pushing the rhetoric of their national champions that had been barred from doing it themselves directly. Re-

gardless of what one thinks of the text in question, this illustrates perfectly how the phenomenon of regulatory capture functions in the EU: through proximity with national authorities, local financial interests make their way in a very effective manner into the EU lawmaking machine and manage in many cases to have the last word thanks to a less than perfect EU governance that has not decided who should have the last word between the institutions representing European interest (European Commission and Parliament) and the institution representing national interests (European Council) and that, in reality, has given a clear advantage to national interests over European interests as political careers are still made at national level.

### **What Conditions Should Be Put in Place in Order to Limit, If Not End, Regulatory Capture in the European Union?**

First of all, it has to be said that a significant number of high level European politicians, regulators and civil servants, in particular – but not exclusively – in European institutions and agencies, are very conscious of the necessity for society to fight regulatory capture. Regulatory capture is very much a systemic question more than a question of persons and addressing the issue will therefore require, in my view, a thorough real world approach that should concentrate on improving the system.

We saw that regulatory capture derives from the combination of national proximity between regulators and regulated entities with the complexity of the European lawmaking process. The complexity of the EU lawmaking process being what it is, and given the fact that we have little perspective of making it evolve in the short term, we

should concentrate on improving the national proximity situation.

This, very simply, can be done by increasing the distance between regulators/supervisors on the one hand and regulated/supervised entities on the other hand. And the best way to achieve this is to broaden the mandate of regulators.

The good news is that, as we know, this is what is actually being done in the EU. And I believe that with all its imperfections linked both to the time any ambitious project takes to implement in the real world and to the imperfections of the EU itself (obviously a much broader topic), the EU is on the right track to at least diminish in a significant manner regulatory capture in the field of financial services.

Let me illustrate my point with a brief reference to the main two pieces of financial supervision architecture that the EU has been working to put in place over the past five years.

The first one is the European System of Financial Supervision (ESFS) that led to the creation of the three European Supervisory Authorities (EBA, ESMA and EIOPA) and of the European Systemic Risk Board (ESRB) in 2011. Even if the ESFS still depends to a large extent on the relationship with national supervisory and regulatory authorities for reasons linked to the very nature of the European Union, it is without doubt a step in the direction of creating a more integrated European financial system that will have increased chances of functioning in a coherent manner with less chances of being captured by specific interests.

The second one, obviously, is the banking union with its two institutional pillars respectively in charge of the single supervision of European banks and of resolving them if and when need be. Regardless of all the challenges that they will have to overcome, the mere

fact that they will operate at European level will make the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB) less prone to (if not immune from) regulatory capture than would be the case (or was previously the case) with national supervisory or resolution authorities.

It seems clear to me that the European Union is putting in place today a regulatory and supervisory architecture that – everything else being equal – will be better equipped to fight regulatory capture than it was the case in the past. This is without doubt a step in the right direction.

## Conclusion

One last dimension of regulatory capture that must also be borne in mind is the situation created by the combination of size and complexity of the financial system: When a system becomes so large and so complex, policy-makers reach a point where they can decide, consciously or unconsciously, not to reform what needs to be reformed from fear of the unintended consequences that their regulatory actions could trigger. In other words, fear of the unknown triggers immobility. A sort of negative interpretation of the “principle of precaution” and, without doubt, a recipe to change nothing and give up on regulating what needs to be regulated.

The issue of size is particularly sensitive in the EU context as the European financial services industry seems to be on a path of never ending size expansion which makes it, by construction, always more powerful. Between 2001 and 2011, the cumulated balance sheet of the EU banking sector grew by 80% to reach EUR 45 000 trillion (350% of EU GDP). The cause of this expansion is, as we know, the notorious “too big to fail” syndrome and the funding subsidy derived by “too big to fail”

institutions which feeds a phenomenon where size feeds size. The power of the biggest financial institutions has never been as important as today.

Admittedly, there is a point in the argument saying that legislators and politicians are not equipped to deal in detail with all the complexities of a financial sector which has become, indeed, so large and so sophisticated.

This is why I believe that the trend that we are seeing today where more and more so-called level 1 legislations delegate very important rules to regulators to be elaborated at level 2, makes sense.

We can see this, for instance, in the importance of the level 2 work to be realized on MiFID 2 but also in the proposal of the European Commission to reform the structure of the EU banking sector. Typically the impact of those two texts, the first one having now been adopted at level 1 and the second one still to be discussed by European legislators, will depend on the work done by regulators at level 2.

In my view, banking union is also a case in point in that respect. Banking Union has the right objectives and has put in place a system which is a very significant progress towards diminishing moral hazard in the banking sector and eventually reducing the doom loop between European sovereigns and European banks.

Journalists often ask me whether banking union will achieve its objective of protecting tax payers against potential bank defaults. And my answer to this question is “it will depend”, which usually creates a frustration with the person who asked the question and who was expecting a clear “yes” or a clear “no” as an answer. And the complete answer is: “It will depend on the way regulators and supervisors apply the rules and perform their duties without being captured.” Banking union, in

particular in its Single Supervision and Single Resolution dimensions, has all the potential to improve in a considerable manner the situation of the EU banking sector but whether this potential converts into reality will depend crucially on the way regulators, supervisors and resolution authorities use the tools that have been put in their hands by legislators. The Single Supervisory Mechanism (SSM) is now well on its way to being established and what we are seeing gives us, despite the difficulties inherent to this exercise, many reasons to be optimistic on its ability to deliver on its crucial mission. On the SRM side, it is obviously too early to have a view on the yet to be established Single Resolution Board (SRB) but its role will be as important as that of the



SSM and the ability of the SSM and of the SRB to cooperate will be essential to achieving the objective of the banking union.

All this leaves a historical responsibility on the shoulders of European regulators, supervisors and resolution authorities which will need to make sure that they do not get captured in the course of exercising their extended responsibilities. The financial stability and therefore the social cohesion of our societies depend on it. Thank you for your attention.