A New US-European Rift on Financial Regulation

Nicolas Véron says that Europe's determination to regulate private equity and hedge funds, which has drawn criticism in Washington, is part of a growing trend toward a "Fortress Europe" mentality in finance.

Edited transcript, recorded March 15, 2010.

Steve Weisman: Is the United States headed for a new confrontation with Europe, this time over financial regulation? This is Steve Weisman at the Peterson Institute for International Economics, again with Nicolas Véron, visiting fellow here at the Institute and senior fellow at Bruegel in Brussels. Nicolas, thanks for joining us to talk about it.

Nicolas Véron: Thanks for having me.

Steve Weisman: Treasury Secretary Timothy Geithner has criticized the European Union for their plan to increase regulation in a number of areas, including derivatives. He is saying that their regulations almost seemed designed to thwart the opportunities for business by US private equity and hedge funds in Europe. Is there anything to his criticism?

Nicolas Véron: It's an extremely interesting case because I, for one, certainly see it as the shape of things to come in the international regulatory debate on financial services between the United States and Europe. In this case of regulating private equity and hedge funds, the European Union's intent is not protectionist. It's just a re-regulation effort, largely linked with the financial crisis, driven by political motivations as well as policy motivations, which is about turning the screws to have a more demanding regulation of hedge funds and private equity. You can question whether the way the screws are turned is the right one. And because this legislation is very politically driven, it's probably questionable in some of its aspects, but it's basically regulating more.

Of course, as they want to avoid regulatory arbitrage, they say, "Well, if funds [that] are managed outside of the European Union want to be distributed in the European Union, like the funds from the European Union, then they have to comply with the same regulations."

And of course, this is seen by the United States as unilateralist because there is, at this point, more freedom for European-managed funds to be distributed in the United States, so there is an asymmetry here. But again, I think the intent is not protectionism; it's unilateralism. This is new because in the prior eras—say the last two decades—the United States tended to be unilateralist in its regulatory moves, typically Sarbanes-Oxley, a very good example, but Europe was more internationalist. So we have a new context here.

Steve Weisman: You mentioned the last two decades but even in the first G-20 meetings of 2008 and then last year there was talk of international coordination in the regulatory areas. Is this shift even from the talk of cooperation a year ago?

Nicolas Véron: Well, I'm not sure because large economies—developed economies—always pay lip service to international economic cooperation. They say they want a level playing field;

they remain fundamentally committed to open their markets when it comes to the general picture but the devil is in the details in terms of financial regulation. And so, the classical pattern again has been everybody being rhetorically committed to international coordination and harmonization, but acting unilaterally when it's about turning the screws in financial regulation. Again I think the only thing that's new here is that Europe is no longer committed to financial services liberalization per se. It's getting much more active in reregulating its system, in a way that we really haven't seen in the past two decades. This probably will create a number of tensions with the United States.

Steve Weisman: Well, this really started before the financial crisis though, didn't it, Nicolas? I mean, the Germans were criticizing hedge funds and private equity funds as locusts before even the crisis hit in mid or late 2008. So, I'm wondering if there isn't a little bit of, if not protectionism, at least homegrown bias against what sometimes is called Anglo-Saxon form of capitalism.

Nicolas Véron: You're right to say that there is a lot of continuity in those issues always, but I think there is a big change at the level of the European Union itself, of the European Commission, and Parliament. So the traditional pattern in the European Union in the 1990s and 2000s has been the European Union being a liberalizing force against national member states, which had more protectionist, knee-jerk reactions, or reference points in their own domestic debate, as you mentioned the locusts in Germany. And of course, this is by far not unique to Germany.

But I think the shift, if there is one—and I believe there is one—is taking place in Brussels, at the level of the EU institutions, because prior strategy was basically about achieving internal market integration, which is a mandate of the EU institutions. Soon liberalization is no longer attainable. So, EU institutions are still committed to internal market integrations—that's what they are created to be—but the strategy of pushing this through global and regional liberalization can no longer be the core strategy as it was before the crisis, because there is a much more important emphasis on financial stability, and you need reregulation to achieve that arguably.

Steve Weisman: Is this an example of what you've called "fortress Europe" and what are the consequences for economic recovery and growth?

Nicolas Véron: Indeed, I think that without making it too dramatic, in the next few years we may see more of the European Union trying to safeguard and expand the integration within the EU internal market, not by liberalizing as before but by reregulating at the EU level as opposed to the national level. So, there is a sort of race between the national level and the EU level to reregulate the financial system, given the huge political pressure we're experiencing.

And so there is a competition, which now is driving power to more regulation at EU level, not less as before. And if this is so, my sense is that at this point, global financial integration becomes an afterthought for the European Union, including transatlantic. Therefore we should see a bit of financial fortress Europe emerging through these regulatory drives at least, if not in changes from the current path.

Of course, there are many counterforces and I'm sure that there will be active discussion between the US authorities and the EU authorities, and there may be some corrections of course. But we see a very powerful political dynamic pointing in that direction right now.

I would imagine the current spat about private equity and hedge funds to be just the first of a series. And arguably, there are already a number of other issues. There is US assertiveness to have Europe's own located platform for derivatives and clearing of derivatives, while the United States tends to argue for one single, global clearing mechanism.

There is an EU regulation of rating agencies, which has actually already been enacted last year, which creates the possibility—which has not materialized so far but it's still very early days—of different regulatory orientations on rating agencies from the US and EU authorities, which may create differences of methodologies between the United States and European Union, which would be of course very problematic, because the whole proposition of rating agencies is that they have a single, global methodology for assessing risk.

At this point, there is nothing really seriously endangering transatlantic business flows, but we're seeing more and more of these indications and again, I see no reason why this should be seen just as a blip.

Steve Weisman: And finally, you mentioned a regulatory arbitrage, which is the phenomenon of people who feel restrictions in one part of the world just taking their business elsewhere. Why wouldn't that just happen now?

Nicolas Véron: This is certainly part of the equation: both the European Union and the United States are very large economic areas. It's not the same as if you're a small open economy, if you turn the screws, business activity will immediately be diverted to some neighbor. It's less obvious for the European Union. Even so, there are a number of offshore financial centers, which are right in the center of the European Union, as is the case for Switzerland, or in the immediate periphery.

So, there will be a question of how much the reregulation inside the European Union diverts business towards these centers. There will certainly be pressures from the European Union for these centers to also adapt the sort of screw-turning that the European Union is adapting. And the European Union has some instruments for that sort of pressure typically with Switzerland. So it will be interesting to observe.

I think regulatory arbitrage is a real check on political impulses to introduce perhaps sometimes excessive regulation of the financial sector, but I don't think at this point we're in an environment where it just makes EU policymakers powerless or US policymakers powerless. Actually, what we have seen last year was the sort of backlash against tax havens, and G-20 agreements to basically restrain tax havens. Maybe that's just the beginning of a concerted effort by law jurisdictions just to make this regulatory arbitrage more difficult, and I think we're already seeing a bit of this.

Steve Weisman: Nicolas, thanks very much.

Nicolas Véron: Thanks to you.