The deficits of the EU financial reforms

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Almost one year after financial market turmoil triggered a financial and economic crisis in the countries of the European Union (EU), many reforms of the financial sector are still not in place and destabilising practices are continuing. Political agreements at several high-level international and European meetings still need to become legally binding through EU directives and the subsequent incorporation into national laws. Will the financial sector reforms currently proposed at the EU level guarantee financial stability and protect the real economy from financial speculators? More importantly, will they create financial instruments at the service of the public interest and sustainable societies, and tackle the systemic causes that also are related to the food, environmental and poverty crisis?

This briefing provides a critical analysis of a selection of the European financial reforms that are being discussed and decided upon in the second half of 2009 and beyond. An in-depth explanation of the EU financial reform proposals that are discussed in this paper, as well as the terminology and the political decision-making processes at EU level, can be found in: "An oversight of selected financial reforms on the EU agenda" (See on the SOMO website <www.somo.nl> the Financial Sector dossier).[1]

Socially useless financial innovation

While the rescue operations of the financial sector have exposed the central the role of financial services in European societies, the usefulness of the current banking sector and its activities to society have hardly been discussed. When high bonuses were again being paid in the summer of 2009, a more open debate arose about the lack of reforms and how parts of the financial services sector had outstripped 'their economic and social utility as well as the operational capacity to manage them'[2]. This related especially to 'innovative' and speculative derivatives trading, hedge fund and private equity industry activities, investment banking and 'securitisation'. This debate challenged the desirability of just propping up the current financial system that has 'financialised' the economy, allowed huge profits for a few from activities that were not much use to anyone else and resulted in an unbalanced relation between income from labour and income from capital.

As discussed below, the EU's approach to reform those risky and complex sectors has not assessed nor integrated these essential issues. Rather, it focused on removing some risky behaviour that it considers to contribute to a financial crisis and was highly influenced by continued political power of the financial sector.[3]

Hedge funds and private equity want business as usual

Hedge funds, private equity and similar speculative funds have contributed significantly to the instability of the financial markets and the quest for the highest financial returns. They have risky and aggressive short-term profit strategies, using great quantities of borrowed money ('leverage') and dubious tax strategies. Hedge funds accounted for over 50% of the daily volume of trading in equities and were among the leading buyers and sellers of speculative and structured financial products related to the sub-prime mortgages which triggered the financial crisis. In the next years, up to 40% of companies owned or controlled by private equity funds could default on their debts or go out of business, involving more than $ 1 trillion.[4]

These so-called 'alternative' investment funds are currently not yet directly regulated or transparent. In April 2009, the European Commission (EC) finally proposed a directive to somewhat regulate the transparency and capital reserves of EU-based managers of 'alternative' investment funds (AIF), instead of the funds themselves. At the same time, the EC proposes to allow those managers to move more freely within the EC. The huge hedge fund and private equity lobby was swift to argue that the proposal would restrict their activities and impose considerably higher costs. Other critics, including the greens and social democrats in the European Parliament, are claiming that the proposed directive has many shortcomings, such as:

- Only around one third of the AIF managers will be covered as the Directive only applies to managers with fund of € 100 million or more.
- The proposed capital requirements (starting at € 125,000) are too insignificant to avoid financial instability or cover large financial losses.
- The lack of EU requirements on registration may result in Member States with the most relaxed requirements attracting the most registration of these managers who will then be allowed to operate freely in the EU.
- The level of leverage is not regulated and can only be limited when considered necessary by the EC and the supervisor of the country where the manager is registered.
- None of the speculative and aggressive short-term profit oriented investment strategies, such as short selling, nor activities with negative economic, or social and environmental impact are regulated or forbidden.

Only making derivatives trading safer and more efficient

The derivatives markets are a major part of the financial casino and do not always hedge against price instabilities as often claimed. Trading in derivatives, estimated at almost $ 700 trillion in notional amounts outstanding (June 2008) is nontransparent even for supervisors, as around 85% happens 'over the counter' (OTC). The riskiness of complex derivatives and the interconnection between traders were at the heart of the financial crisis and their nontransparent markets contributed to the halt in lending.

In July 2009, the EC announced initiatives to make trading in derivatives 'more safe, efficient and sound'. The EC's main approach is to use voluntary market based instruments and incentives. It promotes more transparency with respect to the volume and risks of derivatives trading through more standardisation of derivative contracts, more trading on exchanges open to all traders and more data collection. To avoid instability problems in case of large payments defaults, the EC promotes a.o. the use of central counter-party clearing whereby one intermediary company becomes responsible for executing all derivatives trading by buying and selling all the derivative contracts of its clients.

How can these proposed voluntary instruments be acceptable if the EC admits that they even might not achieve full transparency nor cover all derivatives trading? What's more, the EC does not intend to restrict speculative activities that are harmful or 'useless' for society, such as speculation in food prices and carbon emission trading. In the mean time, speculative trading in derivatives, even the most risky ones, has continued.[5]

Protecting securisation rather than bank clients

A major financial innovation that triggered the financial crisis were the so-called processes of securitisation through which (sub-prime mortgage) loans and other illiquid assets (e.g. credit card receivables) were pooled together, (re)packaged in complex financial products and sold, often through nontransparent off balance sheet entities and tax havens. Since this encouraged risky lending to poor citizens and allowed circumvention of capital reserve regulations, the EU agreed that those issuing the securitised products need to retain 5% of them. This has been criticised by many to be insufficient to at least make securitisation less destabilizing. In July 2009, the EC made proposals to improve the risk management of re-securitised financial products, rather then forbidding these speculative products. Protection of citizens against dangerous loans is to be improved at the EU level through EC proposals in June 2009 promoting 'responsible' lending and borrowing.

No end in sight for moral hazard and shadow banking

Too much focus on bonuses

The angry public discussions about perverse bonuses have not yet resulted in legal restrictions on remuneration at EU level, although EU leaders have taken limited action at national levels and pushed certain principles and binding rules on the G-20 agenda in September 2009. The EC's interesting recommendations in April 2009 on remuneration have remained non-binding, while the current EC legislative proposal requires

only that banks have supervised remuneration policies of any kind. The 'moral hazard' causing governments to use tax money to prevent a financial meltdown ('socialising losses') created by the risk-laden innovations that were a source of huge financial gains to financial operators and shareholders ('privatising profits') will remain unresolved as long as banks can continue to become too big to fail. The EC and EU member state consider that imposing higher capital reserves on banks, insurance companies and some financial operators (see above) should safeguard the economy and governments from having to pay the price of financial instability and risky products. The agreed and to be agreed new amendments of the Capital Requirements Directive (CRD) are, however, so far very limited in scope. The EU will only implement higher capital reserve requirements for banks after conflicts are being resolved at the G-20, and details worked out at the Basel Committee of Banking supervision.

Off shore financial system to continue

The current proposed second amendment of the CRD would continue to legitimate, instead of forbid, off-balance-sheets which were the main instruments for shadow banking and financial market distrust that triggered the financial crisis. According to the above discussed EC proposal to somewhat regulate hedge funds and private equity, 'alternative' investment fund managers will in the future have to ensure that funds from third countries they market and use, satisfy 'certain regulatory, supervisory and information exchange requirements'. However, these requirements are far from resulting in a much needed automatic exchange of information, nor will they stop the presence of hedge funds, private equity and nontransparent financial 'vehicles' in secretive and lowly regulated tax-free jurisdictions.

As governmental budgets are showing growing deficits due to economic and bank rescue measures, the EC is starting to improve mechanisms and legal instruments to limit tax evasion and tax avoidance among EU member states and through third countries. Through proposals to amend the Savings Taxation Directive, the EC aims at preventing tax avoidance by EU based individuals who deposit their savings abroad and use innovative financial products and intermediate legal persons or structures. However, not all forms of capital income are covered by the Directive nor all legal entities, such as trusts located in the United Kingdom, which are widely used.[6] Little is being done so far to stop tax evasion and avoidance by companies using low-tax systems within and outside the EU.

New interest in a financial transaction tax

Many methods to fund financial sector losses (and their economic impacts), stop excessive profits, and eradicate shadow banking and tax evasion have not been considered at EU level. At the end of the summer of 2009, however, one such method has been supported by the UK Supervisor Lord Turner, some high level politicians in Germany and France, and some political parties: the introduction of a financial transaction tax on all kinds of financial transfers or a tax on foreign exchange transactions (Tobin Tax). As of mid September 2009, there was no political will at EU level to integrate the proposal in EU reforms.

Reform of supervision incomplete

The financial crisis has exposed the dangers of the current fragmented European supervision with as many as 80 national and sectoral supervisors responsible for EU wide cross-border financial operators and products. To improve the situation, the first review of the Capital Requirements Directive made the establishment of 'colleges' of national supervisors for particular financial conglomerates compulsory.
In autumn 2009, the EC will also present legislative proposals for a new European System of Financial Supervisors, composed of the European Supervisory Authorities (ESAs) that each comprise national supervisors for banking, insurance and securities markets. They are a reformed version of the already operating European supervisory committees and will have some new mandates such as binding mediation in the exceptional case of disagreement within a college of supervisors. Nevertheless, many issues are to remain under the control of the home supervisor such as the internal risk models of financial firms. In order to assess macro-economic dangers building up in the financial system as a whole, the EC proposes a new European Systemic Risk Board (ESRB). However, the ESRB would only be able to issue warnings, which may well be ignored in good times and kept secret during a crisis for fear of sparking panic.

The proposed supervisory structure is considered by many to be inadequate to deal with a complex cross-border financial industry while there is no agreed formula on how to share the burden of the costs to rescue European cross-border banks.

Governments trapped in regulatory and supervisory arbitrage

Many important aspects are still missing on the EU financial reform agenda, but also nationally and internationally. For instance, there is no proposal on the official agenda to at least separate more ordinary, commercial banking from risky investment banking. On the contrary, many investment banks were rescued and merged in a way that they are now deeply embedded into banks that have more than ever become 'too big to fail'. Many other contradictions are also still left untouched, for instance the EU pushes to finalise the free trade negotiations of the WTO's Doha agenda while this would include liberalising useless and badly regulated financial services internationally, and implementing the deregulatory rules of the WTO's services agreement (GATS).

The slowness and the weakness of the financial reforms currently on the EU table reflect how national governments, regulators, supervisors and the EC continue to consider it as their task to protect the attractiveness and competitiveness of the financial industries in their respective countries, which are seen as important sources of income and jobs. In the past, the financial sector has gained enormous political power by moving to less strict countries, or threatening to do so. As a result, the Member States have set regulation and supervision as low as possible and liberalised the financial sector (at home and worldwide), which allowed the financial industry to become 'too big to fail' Now, continued political support for the of the financial sector through low regulation is conflicting with governments' task to protect the public interest.

Against this continued focus on competitiveness and so-called regulatory and supervisory arbitrage, more analysis is needed which can project what size or financial sector models would be economically and socially useful and fulfil the public interest in a sustainable way. The report by France's Commission on the Measurement of Economic Performance and Social Progress[7], lead by Prof. Stiglitz, might be of use to define and promote a financial system that will serve especially those who most need it, reverse climate change, promote food security and sustainable energy.

More public debates and protests will be needed to press for the integration of the mounting critiques and fundamental issues into the reform agenda. In conclusion, a major overhaul of the EU financial reform agenda is required.

Endnotes

1 Unless otherwise specified, figures, EU financial reforms proposals and terminology used in this briefing can be found in that document, see <http://somo.nl/dossiers-en/sectors/financial/financial>

2 P. Jenkins, Art. 'Goldman chief hits at "useless" banking', Financial Times, 9 September 2009

3 See recent and other publications at : <http://www.alter-eu.org/>

4 The Boston Consulting Group, IESE Business School, 'Get ready for the private-equity shakeout?', December 2008.

5 See for instance: D. Enrich. D. Paleta, Art. 'Finance overhaul falters as '08 shock fades', The Wall Street Journal, 9 September 2009.

6 See among others: R. Murphy, Richard, 'Plugging the gaps: reform of the EU savings tax directive', Tax Justice Network, 2 December 2008, <http://www.taxresearch.org.uk/Documents/Plugginggaps.pdf>

7 <http://www.stiglitz-sen-fitoussi.fr/en/index.htm>: The Commission's report was published on 14 September 2009.

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