Weltwirtschaft, Ökologie & Entwicklung
World Economy, Ecology & Development

Fighting Fire with Buckets

A Guide to European Regulation of Financial Markets

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Imprint:

Wahl, Peter: Fire Fighting with Buckets. A Guide to European Regulation of Finance

Published by: WEED - World Economics, Environment & Development Assoc.

Eldenaer Straße 60

D-10247 Berlin

2010

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This publication has been co-financed by the *Ford Foundation.*
The views expressed are those of the author, and cannot be attributed to the *Ford Foundation.*

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List of abbreviations

AIFM	Alternative Investment Fund Managers
AIFs	Alternative Investment Funds
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht
BIS	Bank for International Settlements
CCP	Central Clearing Parties
CDS	Credit Default Swaps
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions
CESR	Committee of European Securities Regulators
CFTC	Commodity Futures Trading Commission
CRAs	Credit Rating Agencies
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs
EIOP	European Insurance and Occupational Pensions Authority
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
FAT	Financial Activities Tax
FSF	Financial Stability Forum
FTT	Financial Transaction Tax
GDP	Gross Domestic Product
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
OTC	Over the counter
REITS	Real Estate Investment Trust
SEC	US Securities and Exchange Commission
UNCTAD	United Nations Conference on Trade and Development

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SUMMARY

The paper argues that the EU has been caught by surprise by the financial crisis. There was a strong belief in the efficiency of financial markets and in their capability to regulate themselves. Liberalisation and deregulation of finance had been on the agenda of the EU for many years. Warnings, that there were increasing risks were thrown to the wind. Insofar the EU bears a certain co-responsibility for the crisis. When the crisis broke out, the EU was marginalised. Crisis management was in the hands of the member states. The financial crisis has revealed the structural problems of the European integration process. There is a heterogeneity of economic models and respective interests, for instance between the Euro zone and the non-Euro zone, between the UK with London as the biggest financial market place, and the continent, between deficit and surplus countries, between domestic demand driven economies and export led models. The crisis has deepened the contradictions inside the EU culminating in the Greek crisis.

The paper presents the major reform projects: European supervision, regulation of Credit Rating Agencies, regulation of Hedge Funds, Private Equity Funds etc., regulation of OTC derivatives trading, short selling and Credit Default Swaps, measures to make the financial sector contribute to the costs of crisis, capital requirements and a broader framework for crisis prevention and management.

In general, the proposals address relevant issues and suggest steps into the right direction. But they are not going far enough and are watered down in the process of law making under the pressure of the finance. A basic problem remains, that the transfer of power to the supra national level is insufficient. Furthermore, compared to the US the EU is lagging behind. The decision making process is more complex than in a nation state.

The paper comes to the conclusion, that the EU regulation will increase financial stability to a certain extent. But there are important issues that are not being addressed. Besides others these are a substantial reduction of speculation, the problem of "*too big to fail,*" a reform of the European Central Bank and offshore centres and fiscal paradises.

The biggest shortcoming however, is the restriction of the reform approach to issues of financial stability. Although financial stability is a public good, which should be promoted, it is not enough. The inseparable linkages of finance with the real economy, with labour, social security, taxation etc. require a systemic approach. Thus the dominance of finance of the real economy has to be broken, the whole sector has to shrink and address the issues of distribution and the imbalances at European and at global level. It is not enough to make the casino safer. It should be shut down. A paradigmatic shift is required, especially in the light of historically exceptional challenges, such as climate change, poverty and shortage of important commodities. The world needs financial markets at the service of sustainable development and of social equity at the global level for the coming decades. The EU reform package is by far falling short of these requirements.

1. Introduction

The financial crisis which started in 2007 in the real estate sector of the US and turned into a global crash in September 2008 is "*the most serious and disruptive financial crisis since 1929"* as analysed by the de Larosière committee, established by the European Union (EU)[1] to assess the crisis and to make recommendations (de Larosière 2010:6). The crisis has caused worldwide losses amounting to about 3.4 trillion Euros according to estimates by the International Monetary Fund (IMF). That is more than the GDP of France and twice the GDP of Brazil (IMF 2009a). It has provoked a global recession, caused unemployment, enormous social stress and a huge public debt in most countries. Its consequences will last on for years. In other words, the crisis is a historic event of great importance.

Although the crash was triggered by the bubble in the US real estate sector, its causes are rooted deeper. It is a systemic crisis. If it would not have been the real estate sector it could have broken out earlier or later in another area. It was the collapse of a system that began to emerge with the end of the fixed exchange rates regime in 1973, and the subsequent liberalisation and deregulation of the financial markets. These, together with so-called innovations, where speculation became the central business model, caused the incredible dynamics of finance in the 1990s and in the first decade of the 21st century.

Mainstream academics call these developments *financialisation* (Bischoff 2009). Others, for instance UNCTAD, describe it in the Keynesian tradition as a big *casino* (UNCTAD 2009: 60), and still others refer to it as *asset and wealth centred capitalism* or *financial market capitalism* or *finance-driven capitalism* (Huffschmid 2002; Windolf 2005). How ever one might call it, it is obvious that a new kind of economy had emerged. Until then, the financial sector played a secondary and subordinate role in relation to the real economy. Its task was to enable payment transactions and to provide credit to companies, households and the state, whereas today the financial industry dominates the economies of the industrialized countries. The original relationship – the financial sector as a service provider for real economy – has been turned upside down. Moreover, the logic of the financial markets, with profit maximisation under all circumstances as the one and only rationale, is being transferred in manifold ways to the real sector.

As a result inequality was dramatically increased. On the one hand real wages in almost all industrialised countries stagnated or declined over many years (FES 2010), whereas capital income skyrocketed. Furthermore the gap in the distribution of wealth increased enormously through redistribution from below to above and from public wealth to private pockets.

In order to keep up consumption of households in spite of declining wages, the US followed the strategy to flood the markets with cheap money, thus fuelling private debt and real estate speculation. One reverse side of this debt based support of private consumption was the increase of the current account deficit[2] of the US, particularly with China. The US has been accumulating an ever increasing deficit from the beginning of the 1990s. It amounted to 700 billion USD in 2007 (US Census Bureau 2010), which corresponds to 5.0 % of the US GDP. This means that the country imported 800 billion USD worth of goods more than it exported, the biggest proportion

[1] With the term *European Union*, *EU* or simply *Union* we mean the supranational level of the European Institutions, in particular the Commission, the Council, the European Parliament, the European Central Bank, the European Court of Justice and their attached agencies.

2 The current account results from the balance between imports and exports of goods, services, remittances and official development aid.

coming from China, which realised a surplus of 11.7% of its GDP. The deficit was paid with US bonds which were mainly purchased by the Chinese.

In other words, the USA has incurred debts with China in order to finance their own consumption. This problem is in the heart of what is called "*global imbalances,*" which of course do not apply exclusively to the US and China. The UK and Ireland also followed a strategy based on debt, and Spain had a huge real estate bubble as well (see Stiglitz 2010).

These linkages reveal, that the crash is not only a problem of the finance system in the narrow sense. *Systemic character* of the crisis means that it is the specific type of economy, which has emerged in the industrialised countries in the last three decades.[3] This is why, a decisive criterion to evaluate all attempts to financial reform has to be whether the systemic character of the crisis is addressed or not.

The perception that we are dealing with a new system of capitalism, is even shared by some representatives of the political elite. In his speech at the World Economic Forum 2010 in Davos, the French president said: *„I want to very clearly state that the globalisation of savings has created a world in which everything was given to financial capital and nothing to labour, where the entrepreneur was secondary to the speculator, where the capital owner was privileged above the employees, where the leverage – the whole world only talks about 'leverage' – has assumed irrational dimensions. All this created a capitalism in which it was normal to gamble with money, preferably other people's money, to obtain money easily and extremely fast, without any effort and often without creating wealth or generating employment with these huge amounts of money"* (Sarkozy 2010).

Even if the fear of rebounding, the so-called "*double dip*", should prove to be unjustified, the consequences of this crisis will still be felt for many years.

The question, whether the lessons have been learnt remains open for the moment, even though the rhetoric of politicians were quite strong

We have the same phenomenon in the EU: the analysis is often quite clairvoyant (see chapter 4). But the practical consequences remain usually far behind. Two years after the bankruptcy of Lehman and after four G20 summits the US have at least adopted a reform package (see Box 6). Harsh opposition from the Republicans and strong lobbying from Wall Street has watered down quite a lot of the initial intentions. But still, there is at least something. Historic evidence shows, that the momentum for reforms is slowing down if the immediate emergency seems to be over. This is why the time factor has a direct influence on the quality of reforms.

The EU is lagging far behind the US. Nothing substantial has happened by now, although there are now several projects in the pipeline of the decision-making process in the EU.

With this overview on the EU response to the crisis we hope to contribute to the understanding of European policies both outside and inside the EU. Given that most of the EU reform proposals are still on the way, this text is conceived to be a work in progress. An updated version will be published in 2011.

Berlin, September 2010

3 This is why most emerging economies were less affected by the crisis. Chinese capitalism, the models of India or Brazil are centred on real economy and finance is still subordinated to the real sector. Therefore contagion mainly came through real economy relations.

2. The role of the EU in the crisis

The Crash has caught the Institutions of the European Union completely by surprise. Even in July 2008 when the crisis in the US had already fully unfold and contagion had reached several European banks, former commissioner for Internal Market, McCreevy, proposed a range of new measures which would have made it easier for Hedge Funds to operate with less restrictions. He was supported by the conservative parties in the European Parliament (Pinzler 2010:5). And in July 2008, two month before the collapse of Lehmann, the European Central Bank (ECB) increased its interest rate to the historic high of 4,5% to combat a non existing inflation, while the crisis, which had begun in 2007, had already reached European banks – for instance the British Institute *Northern Rocks* had to be nationalised in February of 2008, and the German IKB had gone bankrupt in July of 2007.

2.1. The EU – frontrunner of financialisation

The surprise of the EU is not surprising. The EU has been a frontrunner of liberalisation and deregulation for two decades, both inside the Union and outside.[4] The freedom of capital flows is the fundament of the internal market. Already the treaty of Rome stipulates that *“all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.”* (Article 63.1). The Commission, the Council and the ECB were strong believers in the neo-classical mantra that free financial markets would be efficient and could regulate themselves.

Financial liberalisation and deregulation was also a cornerstone in the *Lisbon Strategy* to make the EU the most competitive economy in the world. The mandate of the European Central Bank was shaped according to the neo-classic and monetarist[5] principles (see Box 1). The neo-liberal orientation of the EU in general and the monetarist approach in finance have been the guidelines of the European Union for many years. With the *Financial Services Action Plan* from 1999, a far reaching programme was set up with the intention to adjust the European financial markets to the Anglo-Saxon model and to make the European finance industry more competitive vis à vis the US. Insofar, the EU contributed considerably to the emergence of the new type of capitalism described in the introduction. Consequently, the strict orientation of the EU towards neo-liberalism gave no room to substantial initiatives for regulation or supervision before the crisis. Attempts from the European Parliament, such as the Rasmussen report on Hedge Funds (Rasmussen 2008) were dismissed by the Commission. The rationale of directives[6], which were dealing with financial issues in the years before, has been the deepening of the single market and the increase of the competitiveness of the financial industry. Issues of stability were ignored, not to speak of the effects of financial liberalisation and deregulation on distribution, labour and social affairs. Attempts to persuade the EU to adopt a stricter regulation were rejected. Alexandre Lamfalussy, former Director-General of BIS and chair of a committee established by the EU to deal with financial integration in 2002 reports that when he suggested “*to strengthen cooperation at the European level between finan-*

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[4] In the WTO negotiations on the Annex on financial services in the framework of the GATS for instance, the Commission is until today – two years “after Lehman “ – still pressurizing emerging and developing countries to liberalize their financial sector (see chapter Vander Stichele 2010).

[5] Founded by Milton Friedman, the monetarist theory believes that the regulation of the money supply is the decisive lever to govern the entire economy. As a consequence the combat of inflation is the first and most important policy goal for the central bank.

[6] In EU terminology a directive is a law. It has to be integrated into the national laws of the member countries. In most cases modifications according to specific national conditions are possible.

cial market regulators and the institutions in charge of micro and macro prudential regulation" the Commission "*politely but firmly suggested that we drop the subject*." (Lamfalussy 2003)

The following is said in the de Larosière report on the quality of the EU's performance with regard to the financial system the following: "*Financial regulation and supervision have been too weak or have provided the wrong incentives.*" (de Larosière 2009:3).

In other words the EU bears a co-responsibility for the crisis. With its confidence in the efficiency, the self-regulatory and self-heeling capacities of markets the EU had kept itself armless when the crisis came. The EU found itself in the situation of the sorcer's apprentice: once the ghost had left the bottle, it was difficult to bring him back.

2.2. Marginalised in crisis response and crisis management

The crisis has hit Europe hard. According to IMF estimates, banks in Europe had to write off 685 bn. USD in the first year and are expected to lose another 934 bn. in the following years. (IMF 2009:fig. 1.9)

In the immediate response to the crisis and in the crisis management the EU was marginalised. The lead was in the hands of the national states, but there was no coordination and each member state took the measures, which seemed to be in its own national interest. For instance: Ireland was the first to declare a deposit guarantee, followed by the German government in October 2008. This step, in return, put pressure on the other governments to follow a similar line. The same procedure was followed with regard to rescue packages for the banks. A set of different measures was implemented, ranging from credit guarantees, via capital injections to public equity holding up to full nationalisation (Bischoff 2009; also see box 2).

The only element, which went beyond crisis management at purely national level, had been the reaction of the ECB, which, with the collapse of Lehmann had finally understood that a global crisis had

Box 1. The ECB - the Bastille of neo-liberalism in the EU

Compared to its homologue in the US the ECB was more catholic than the pope. Like no other central bank the ECB is the pure incarnation of the monetarist theory. Therefore its mandate is cantered around only one target: "*the primary objective of the ESCB*[1] *shall be to maintain price stability.*"[1]

This is different from the mandate of the US central bank, which "*shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates*."[1]

The Fed statute does not ignore inflation, but containing inflation is one target at equal level as growth and employment. For the ECB instead, such goals can only be considered, as long as inflation is not affected: *"Without prejudice to the objective of price stability, it shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union."* (article 2).

The crisis has shown, how flawed this position is. IMF chief economist Blanchard wrote in a paper in February 2010 the self-critical assessment, "*that the behaviour of inflation is much more complex than is assumed in our simple models and that we understand the relationship between activity and inflation quite poorly, especially at low rates of inflation."* From there he concludes that inflation targeting should be more flexible and a 2% rate might be too low. (Blanchard 2010:7)

emerged. But this was, of course, limited to the 16 countries of Euro zone. The other eleven countries, among them the UK, have their own central banks and took measures of their own. The ECB injected liquidity into the markets of the Euro zone in order to prevent a total collapse of lending. Furthermore, the interest rate was lowered to 1%, although this was still considerably above the rate of 0-0.25% of the US central Bank. Nevertheless, the countercyclical policies have helped avoiding a total collapse of the financial system as it happened in 1929.

The uncoordinated crisis management continued with the stimulus programmes which should mitigate the spill over of the financial crisis to the real economy. Although the EU summit in December 2008 had formally declared 200 bn. Euro for a European package, this amount was neither additional money nor common or supranational but consisted of the already existing national programmes.

Table 1 Stimulus packages of the six biggest Economies of the EU

	Germany	**France**	**Spain**	**Italy**	**Netherlands**	**UK**
bn. Euro	82	26	40	9	8,5	31
% of GDP	3,3	1,3	3,7	0,6	1,4	2,2

Source: Reuters 2009

It was generated by the member states budgets and used for the respective country. The only supranational dimension was an advanced release of 11,3 bn. Euro (= 5,7% of the European packages), which had already been earmarked before the crisis for the pan European energy net and broadband infrastructure in the period running up to 2012 (EU 2008).

The marginal role of the EU in the crisis continued. When the debt problems of Greece emerged, Germany and France took the lead and negotiated the basics of an agreement, which the other members and the Commission had to accept. The informal power structure inside the EU, which normally tends to disappear behind the complex set of institutions and procedures, came openly to the forefront and high lightened the breaches, contradictions and fractures of the whole construct. A very traditional type of intergovernmental cooperation between the big powers had de facto replaced the supranational.

Box 2. Governments rescuing banks

Governments as shareholders

Netherlands	ING
France	BNP Paribas & Societé Générale
Italy	Unicredit
Sweden	Swedbank
Greece	Alpha
UK	Lloyds and RBS
Germany	Commerzbank

Full nationalisation:

Belgium	Fortis
Germany	Hypo Real Estate
Ireland	Anglo-Irish
UK	Northern Rock

The fragmentation has existed before the crisis. But the crisis has brought to light, that the process of European integration is in a critical situation. The centrifugal trends are very strong at the moment, and the crisis has served as a catalyst making them even stronger.

2.3. The financial crisis – a backlash for European integration

From outside, the EU might be perceived as an economic superpower. With a population – and an internal market - of 500 million, a share of 30% of global GDP, and 40% of global trade the Union seems to be a giant. And the European institutions have an interest to sustain this impression. However, looking more closely, one has to realize, that what seems to be an entity is a hybrid mixture of a supranational union in the making and national states in a highly complex process of integration and interaction. The EU is not a big nation state – the United States of Europe – nor is it just the additive total of its parts. This peculiar configuration is a historical unique phenomenon. There is a constant state of flux - sometimes and in some policy areas towards more homogeneity, sometimes towards more fragmentation.

In the area of financial rules and regulation fragmentation is particularly dominant. This is also the assessment of the de Larosière Commission, which comes to the conclusion, that "*too much of the European Union's framework today remains seriously fragmented. The regulatory rule book itself. The European Union's supervisory structures. Its crisis mechanisms."* (de Larosière 2009:3)

Fortunately there was a de facto shift towards Keynesian policies under the pressure of the crisis. This shift was favoured by the new US administration, which in this respect had learnt the lesson from 1929. In the London and Pittsburgh G20 summits the change was reflected in the difference to the discourse of the G7/8 summits of the previous decades.

However, the leading role in this non-orthodox crisis responses and management was in the hands of the European nation states. The EU as such was paralysed. Its paradigmatic orientation, its structures and rules had proved to be inadequate to meet the challenges of the crisis. The Growth and Stability Pact (Maastricht Treaty) was openly disregarded and in the Euro crisis the ECB had to break its own statutes (see chapter 3.5).

All in all the financial crisis lead to a significant backlash for European integration: „*Governments have jealously guarded their national prerogatives when it came injecting tax-payers money into the banking system, and the size of the EU's existing budget is so small – around just 1% of GDP – as to leave it powerless and marginalised.*" (Euro Memorandum Group 2010:17). The former German foreign minister, Joschka Fischer, which is known as a strong supporter of the long term goal of the *United States of Europe* seems to be right on the mark, when he said that the "*financial markets with their merciless realism have cleared away unsentimentally within few weeks the illusions and half-truths, the unrealistic autism and the continuous self-deception of the EU-Europeans, of their heads of state and government, their media and their political public…*" (Fischer 2010:2)

The question is now, whether the reform projects, which are under preparation (see chapter 4) to regulate finance at EU level are capable to turn the tide. As part of the answer we shall first have a look into the reasons for the weakness of the EU in the crisis.

3. More than national egoism – structural reasons for fragmentation

The fragmentation of European regulation is the result of several deep-rooted structural factors. The first and most important problem is the overall economic bias in the process of integration. Its rationale was market integration, which was already the core of the Rome Treaty from 1957, although economic integration had been limited to the common agricultural policy, the removal of trade tariffs on the inside and common tariffs for outside trade, at that time. And with six countries at tat time[7], the diversity was also far from what we have today. With the *European Single Act* of 1986 and the treaties of Maastricht 1992 and Amsterdam (1997) a single market for goods, capital and services was established and continuously deepened. It created new asymmetries and imbalances inside the EU.

3.1. Transnational markets and national regulation - the basic problem

The new quality of market integration was enshrined in a whole set of hard law which was binding and enforceable through sanctions. Political intervention into the free market, and thus financial regulation was considered to be detrimental. All European legislation in that period dealing with finance was strengthening the economic freedom of markets and restricting anything that could hamper it. It was regulating deregulation. The EU was driving the Union into the same contradiction, which was already the basic problem of globalisation: the asymmetry between free, transnational markets and the restriction of political regulation to national borders. There is no equal level playing field between politics and markets any more. Market forces are privileged vis à vis the representation of the common good. This leads not only toward instability and economic crises, but is also represents an erosion of democracy.

The financial crisis has painfully brought to light the consequences of this contradiction. As Joseph Stiglitz put it: "*This global crisis calls for a global reaction. Unfortunately however, the competences are still located at the national level*." [8] One could add: this crisis calls for a European reaction. However, the competences are still located at the national level. In the absence of an effective EU regulation, the nation state has played the role of the "*salvator of last resort*".

At the same time, other dimensions of integration, in particular the harmonisation of social and labour standards and taxation, that could have constituted a certain counter veiling power to the dynamics of free markets, remained - by intention - in the realm of the national states[9] or appeared at European level at maximum as "soft law", i.e. they were non binding and not enforceable.

Theoretically the EU would have been well placed to handle the basic contradiction of globalisation in a different way. But under the hegemony of neo-liberal thinking combined with the pressure of the financial industry, which was benefiting from the way how things developed, the EU used its potential for the opposite.

Unless there is a paradigmatic shift, which recognizes that there is a need of rebalancing the relationship between market forces and the political, the ghost that escaped from the bottle needs to be taken under strict and democratically legitimate control.

This has nothing to do with sympathy for nationalism, patriotism or similar ideologies of collective identities. The dilemma is, that in spite of its decline, and limitations, the

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[7] France, Italy, Germany and the Benelux countries.
8 Financial Times Deutschland, April 17, 2009
[9] Where they were also weakened in the wave of neo-liberal reforms of the last decades.

time seems not yet ripe to replace the nation state, even in the EU. The nation-state is likely to remain the institutional centre for responding to major crises for a while.

3.2. The split between Euro zone and non Euro zone

The Maastricht treaty has brought about a new fission inside the EU. With the establishment of the Euro zone a sub-group has emerged, in which integration was deeper than with the rest of Europe. 16 countries adopted the Euro and consequently the ECB and the Maastricht criteria, whereas 11 other countries maintain their own currency and sovereignty over their financial system.[10] This means that Europe has today twelve different currencies. The currencies of Bulgaria, Denmark, Estonia, Latvia and Lithuania are pegged to the Euro and Estonia will join the Euro zone in 2011. The Eastern European member countries have all planned to join the Euro, as soon as they fulfil the Maastricht criteria. Poland for instance had considered its entry for 2014.[11] However, in the light of the Euro crisis uncertainties have occurred which might change things.

Independently from that, the existence of twelve currencies in a single market is a problem:

- it is a general obstacle to the integration process,
- economically it increases transaction costs for all operations between the different currencies,
- it constitutes heterogeneous dynamics with regard to inflation and fiscal policies,
- it opens space for currency speculation inside the EU,
- it makes the external economic relations of the EU more complex and more expensive.

On the other hand, an independent currency gives a country more flexibility and options in its economic policies. It maintains the sovereignty over policy instruments such interest rate changes and the appreciation or depreciation of its currency. Interest rates and exchange rates are strategic prices, i.e. they influence all other prices and have thus cross cutting effects for the economy, for export and import prices, for wages, for inflation etc. This is why giving up these instruments is a difficult decision between benefits and disadvantages of entering the Euro zone.

3.3. The UK and the Euro zone

The biggest problem, however, is the fact that the UK is not part of the Euro zone, and there is no chance that this could change in the foreseeable future. The country is the second biggest economy in the Union and the City of London is the biggest financial centre in Europe. The British Pound is still an internationally important currency. Looking for instance at the volume of market capitalisation – an important indicator to assess the size of a financial market – the figure for the UK was 1,962 trillion Euro in June 2010, whereas at the second place we find Germany with 0,903 trillion, which is less than half (Eurostat 2010a). In other words, there is a deep split in the EU with regard to financial markets.

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[10] Bulgaria, Czech Republic, Denmark, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Sweden, UK

11 Sweden had agreed to join the Euro when the country entered the EU in 1995. But a referendum in 2003 rejected the accession to the Euro zone.

This is not only a matter of figures and quantities. Since the eighties, the UK has also taken a lead role at global level in liberalising and deregulating financial markets. It is not by chance that the financial discourse speaks of the *Anglo-Saxon* model. There is a specific culture, which is rooted in the traditions of free market liberalism and which was revitalized in the last decades as neo-liberalism. The belief in the efficiency and the capacity of self regulation of financial markets was particularly strong, and, as the reverse side, regulation and supervision was particularly weak. This is different from the etatist traditions in France or from the German model of *Rhenish Capitalism* or *Social Market Economy.* Although at EU level the British approach was dominating and the continental culture was eroding until the crisis broke out, these differences had not completely disappeared.

Ideological orientations have an impact on the reality. But even more important is the fact that 10% of the British GDP today stems directly from the City of London, and another 10% indirectly. The historical process of deindustrialisation and the strong development of the service sector have established a structure of the British economy, which make it particularly dependent on financial services. Even if under the impression of the disaster of the Anglo Saxon model the UK wanted to change policies, this would require a painful structural adjustment. Every UK government has to take this into consideration. This is not an excuse for the resistance of the UK government and the lobby of the City of London against all substantial reform in the EU. But it shows, that the perspectives of the reform process are influenced by fundamentals, which are not easy to alter.

3.4. A patchwork of different economic models

Beside the special position of the UK in the EU there are several other structural differences between countries with regard to their economic model and its consequences for finance. One group of the new member states, particularly Hungary, Romania and the Baltic states were following a development path, which was based on foreign debt. Investment in infrastructure, strong private consumption and a housing boom were financed through credit in foreign currencies, in particular Euro and Swiss Franks. This was accompanied by a strong presence of foreign banks, mainly Austrian, Italian, Swedish and German banks. When the crisis led to a depreciation of the currencies in the respective countries, debt service became an unsustainable burden. Both private and public debts were skyrocketing (Ehrke 2009). As a result, rescue packages from the IMF and the EU were necessary to prevent a collapse.

Others, like Poland, Slovakia and the Czech Republic were more resilient, because their development is based upon a more domestic frame and can rely on a relatively strong industrial component. In spite of a decrease in growth, Poland was the only country in the EU, which did not fall into a recession.

Finally, there are major trade imbalances inside the EU, which lead to respective current account deficits and surpluses. In particular the German surplus – to a lesser extend also Austria and the Netherlands – which is after China the second biggest surplus globally - constitutes a major problem. As 70% of German foreign trade is within the EU and 50% within the Euro zone the other economies have to suffer from the deficit and an increasing debt burden. In addition to the structural heterogeneity one has to add the multilevel system of decision making in the EU, which is far more complex than in a nation state, even in a big one like the US.

All the asymmetries, contradictions and imbalances taken together lead to a great diversity of particular interests inside the EU. "*The EU is in the economic sphere – contrary to a widespread myth – not at all a supranational actor.*" (Maull 2010: 7).

This heterogeneity is not only an internal problem. It also prevents the EU to play a significant role in multilateral fora. For instance, if the votes of the single European member states in the IMF or the World Bank would be taken together the EU would be the strongest actor. Although the EU is formally represented in the G8 and in the G20 it is not capable to play a significant role as long as its member states have different positions. The rejection of the *financial transaction tax* at the Toronto G20 summit is a recent example. Whereas the French and the Germans had submitted the proposal the UK was against it.

3.5. The Greek crisis – a catalyst of divergence

In the beginning of 2010 Greece was at the brink of bankruptcy. The rate for new indebtedness of the public budget had increased from 3,7% of GDP in 2007 to 12,7% in 2009. The Maastricht criteria allow for a maximum of 3%. The overall public debt had increased from 95,6% to 112,6% of GDP (the Maastricht maximum is 60%). The value of Greek government bonds fell dramatically whereas the CDS were shooting, and the rating agencies were downgrading Greece.

Box 3. Public debt in the EU (%of GDP)

	2007	2008	2009
Austria	59,5	62,6	66,5
Belgium	84,2	89,8	96,7
Bulgaria	18,2	14,1	14,8
Cyprus	58,3	48,4	56,2
Czech Republic	29,0	30,0	35,4
Denmark	27,4	34,2	41,6
Estonia	3,8	4,6	7,2
Finland	35,2	34,2	44,0
France	63,8	67,5	77,6
Germany	65,0	66,0	73,2
Greece	95,7	99,2	115,1
Hungary	65,9	72,9	78,3
Ireland	25,0	43,9	64,0
Italy	103,5	106,1	115,8
Latvia	9,0	19,5	36,1
Lithuania	16,9	15,6	29,3
Luxemburg	6,7	13,7	14,5
Malta	61,9	63,7	69,1
Netherlands	45,5	58,2	60,9
Poland	45,0	47,2	51,0
Portugal	63,6	66,3	76,8
Romania	12,6	13,3	23,7
Slovenia	23,4	22,6	35,9
Slovakia	29,3	27,7	35,7
Spain	36,2	39,7	53,2
Sweden	40,8	38,3	42,3
UK	44,7	52,0	68,1

Source: EUROSTAT 2010b

The reasons for the Greek crisis cannot be reduced to one factor. One set of reasons is domestic, in particular a large shadow economy and a flawed system of income tax, in which the rich and middle classes pay almost nothing, an inflated public sector with strong clientilism and other forms of corruption (see Fricke 2010) as well as open fraud.[12] As a member of the Euro zone, Greece was able to benefit from easy access to credits and favourable conditions for years and thus accumulated debt without having an appropriate strategy to handle it.

But there are also external factors, which have contributed to the Greek calamities: first of all the trade imbalances inside the EU. In the first six months of 2010 Germany had a surplus of 74 bn euro in the intra EU trade, whereas Greece had a deficit of 12,7 bn. Other southern EU countries also had deficits: Spain

[12] Already in 2004 *Eurostat,* the statistical service of the EU, had declared, that the figures, which were delivered to Brussels were wrong and that Greek ministries had transferred faked data. This means, that the problems were well known long before the crisis, but were not addressed by the Union.

-26 bn., Italy -14,2 bn. and Portugal -10,2 bn. As these imbalances are not temporary, they are a source of structural debt for the deficit countries. If the deficit economies are integrated into a single currency there is no possibility to use the exchange rate as an instrument to offset at least temporarily the competitiveness of the surplus countries.

This reflects the fundamental flaw in the design of the Euro zone: having a common currency while there are deep structural differences in the different economies. At the same time the common currency can sharpen the existing imbalances.

As long as there is no macro-economic policy coordination, tax harmonisation and a common social policy, which promote more homogeneity, even the rescue measures that have been taken in May 2010 will have a centrifugal effect. The negotiations were extremely controversial and lead in particular to a degradation of the French-German relations. The French finance minister, Christine Lagarde, criticised publicly the German trade surplus, whereas the Germans blocked a common solution to the Greek crisis for weeks. The Federal government was arguing with the rules of the Euro zone, which in fact exclude the bail out of any member state. Instead the exclusion of Greece from the Euro zone was taken into consideration by Germany.

At the same time anti-Greek sentiments were rising in media and in the public opinion, whereas inversely in Greece the memory of fascist occupation during World War II became an issue all of a sudden. Only when Spain, Portugal and Ireland came under threat and when the Euro started to depreciate under the pressure of institutional speculators, the Germans were ready to compromise. A 750 bn. Euro protective shield was agreed in case a Euro zone member would risk default.[13] In addition, the ECB would – against its rules – buy government bonds from the countries under threat.

But what looks like a final happy end is far from being over. The austerity policy imposed to Greece, which is followed also by all other member states, will only lead to a race to the bottom effect, i.e. that all adapt the austerity plans in the same parallel way. At first glance this might occur as unity. All Europeans are doing the same! In reality it is not a common policy, but parallel behaviour, which is driven by the fear to loose competitive advantages. All Europeans against all the others. As a result the imbalances persist while other problems are aggravated such as low domestic demand, cuts in social and other public spending with all its negative long term effects and the risk of deflation. The underlying structural heterogeneity, however is not addressed.

Hence, the Greek crisis has deepened the contradictions inside the EU in general and the Euro zone in particular. To quote again Joschka Fischer: "*The hard realities confront us, the Europeans, with a frugal insight and a simple alternative. The insight is, that the Status Quo of Europe is unsustainable, in particular not in a global crisis. And the alternative for us, the Europeans is therefore: forward or backward, further integration or the beginning disintegration*." (Fischer 2010:7)

[13] 250 bn. out of the 750 would come from the IMF.

4. The reform projects of the EU

There is a whole package of reforms at EU level. The roadmap for the reforms has been laid out by the de Larosière commission: This group had been mandated by the European Commission to work out an analysis of the crisis and to make proposals for financial reform at European level. Its president, Jaques de Larosière was former president of the IMF from 1978 to 1987, head of the French Central Bank (1987-93) und President of the *European Bank for Reconstruction and Development* (1993-98). The group consists of six further former members, former central bankers or finance ministers from Germany, Italy, the Netherlands, Poland, Spain and Sweden. Their report was published in March 2009. Most members of the group have worked or still work as advisors for major banks: de Larosière for *BNP Paribas*, Masera for *Lehman Brothers*, Issing for *Goldman Sachs*, Ruding for *CitiGroup*.

Unlike the US, which has adopted quite a large reform package in July 2010 (see Box 6) the EU is still at the beginning. No substantial measures have been entered into force by now (September 2010). However, several directives are in the process of law making, others are in the phase of proposals or announcements.

Given the uncertainties of the open process the following reflects the situation in September 2010. The picture might change in the future. By now, the major projects foresee regulation for the following areas:

- European supervision,
- Credit Rating Agencies,
- Hedge Funds, Private Equity Funds etc.,
- OTC derivatives trading,
- Short Selling and Credit Default Swaps,
- Measures to make the financial sector contribute to the costs of crisis,
- Capital requirements
- A broader framework for crisis prevention and management.

4.1. The directive on European supervision

There is a broad consensus that the lack of proper supervision in almost all industrialised countries was an important reason, why the financial system collapsed. The Declaration of the Pittsburgh G20 puts it like this: "*Major failures of regulation and supervision, plus reckless and irresponsible risk taking by banks and other financial institutions, created dangerous financial fragilities that contributed significantly to the current crisis.*"

The same is true for European supervision. Whereas the single market made it possible for the finance industry to operate Europe wide, financial supervision was fragmented behind national borders and national law. The result is regulatory arbitrage, which allows the financial actors to choose the place, where there is weaker regulation and supervision than elsewhere. To give an instructive example: one of the first European banks to go bankrupt was the *Federal State Bank of Saxony* (*Sächsische Landesbank*). Already in August 2007, more than one year before the Lehman collapse, the bank was insolvent. Only a few months before, an official audit through the German banking supervision authority (BAFIN) had taken place. The BAFIN did not find any problem. Independently from that, Price Waterhouse Cooper had also made an audit. They did not find any problem. Finally, there had also been an extraordinary audit by KPMG. They did not find any problem neither (FAZ Net 6.1.2009). The point is: the Bank had a huge exposure in toxic derivatives in an Irish subsidiary. It was this

exposure, which in 2007 pulled the German parent company into the abyss. German law on supervision had simply no provision for the foreign business of the bank.

It is obvious, that European coordination of supervision is vital. Therefore it is an important step forward to address the problem. In September 2009 the Commission submitted the drafts for a new architecture of European supervision (EU 2009b).
There was immediate opposition in particular from the UK, because the draft was giving too much power to the supranational level. A paper of the UK Parliament's Treasury Committee criticises: "*In particular, we believe it is wrong for an ESA to be given power to override the decision of a national regulator and to direct individual institutions.*" (UK Treasury Committee 2010:5). The committee recommends: "*Treasury Committee sees it appropriate for the UK to use veto*" if the British interests are not taken into consideration (ibid:6).

On September 7th 2010 the ECOFIN[14] agreed on a compromise, which strengthened the national component and weakened the supranational. According to this compromise there will be a new architecture for supervision consisting of:

- a European Banking Authority (EBA), based in London
- a European Insurance and Occupational Pensions Authority (EIOP), based in Frankfurt
- a European Securities and Markets Authority (ESMA), based in Paris and
- a European Systemic Risk Board (ESRB), attached to the ECB in Frankfurt.

The compromise was agreed by the European Parliament on September 22nd 2010 and shall enter into force by January 2011.

4.1.1. Supervision for banks, insurances and securities

The new structure will replace the existing three committees, the *Committee of European Banking Supervisors (CEBS),* the *Committee of European Insurance and Occupational Pensions Committee (CEIOPS)* and the *Committee of European Securities Regulators (CESR*), which have completely failed in the crisis and before. The new system should start to operate as from 1 January 2011 (ECOFIN 2010:9).

At operational level, supervision remains at national level. The mandate of the EBA, the EIOP and the ESMA is to elaborate technical standards, to promote cooperation and harmonisation and a common culture of supervision among national supervisors as well as to cooperate with supervisory authorities outside the EU.

Members of committees will be the heads of the respective national authorities, representatives of the Commission and independent persons (experts).

The new bodies can take binding decisions, however, only under specific conditions, which are the following:

- If there is a violation of the standards, or
- If there occur conflicts between national supervisors, and
- In case of a financial crisis.

In these cases the European supervisors have to stick to a certain procedure: they first have to address their decision to the respective national supervisor(s). If these do not implement the decision, the European level has the right to directly intervene at national level.

[14] Commission of European ministers of Finance and Economic Affairs

However, this right is considerably restricted in the case of a crisis through four additional filters:

a. there must be an "*essential violation*" of European laws,
b. the repair has to be urgent,
c. the definition of what is a crisis remains in the hands of the ECOFIN after consultation and thus of the national states (see Box 4),
d. in crises and in case of conflicts of national supervisors member states can contradict a decision of the European authorities, if the sovereignty of a national parliament over the budget is affected; in other words if a decision incurs costs which have to be agreed upon by the parliament.[15]

All this taken together opens a lot of space for interpretation and gives a kind of *emergency break* to each member country to block the intervention of the supervisors if they do not like it.

4.1.2. The European Systemic Risk Board

European Systemic Risk Board (ESRB) is the fourth component in the new setting. Its mandate is to monitor the stability of the finance system in the EU from a macro-prudential perspective. It is an advisory board. The members will be representatives of central banks and experts. Its president for a first turn of five years will be the president of the ECB.

It is probably not detrimental to have such a body. The problem is, that there have been similar boards and councils in the past. But they had no significant impact. Some of them had even been warning from risks such as the BIS or the Financial Stability Forum (FSF), the predecessor of the Financial Stability Board. The problem with such institutions is threefold:

- the personal of these bodies consisted of central bankers and supervisors, which obviously did not understand adequately the system, which collapsed in 2008, as they were caught in the same neo-liberal mindset as the people who were running the system. Both groups were blind for the systemic risks and weaknesses. Therefore, unless such bodies do not incorporate heterodox thinking and outside perspectives they will continue to suffer from intellectual herd behaviour. As long as they all come from the same universities, believe in the same theories and have the same culture, as long as diversity is lacking, they will repeat the old mistakes.
- In some cases, when they had realised some of the risks, they were voicing their concerns very cautiously. Financial stability considerably consists of trust in the markets, warnings can immediately provoke reactions of the markets. A way out would be to act strictly confidential. However, it is doubtful, whether this is possible with a commission with representatives from 27 different countries.
- Finally, in those past cases, when the BIS or the FSF were warning of risks, nobody was listening to them - a phenomenon which could be called the *Cassandra Syndrome*. In times, when things seem to go well, criticism is easily rejected and those, who voice it, are not liked.

[15] This clause had been imposed by Germany. According to a ruling of the German Supreme Court on the Lisbon Treaty from 2009, EU decisions should not override the national sovereignty over the budget.

4.1.3. Who is supervising the supervisors?

The new regulation is a step into the right direction. But it is still far from being a real European, i.e. supranational regulation. The position of the national level is still very strong. There are still so many restrictions and reservations, that it is very doubtful, whether the system will work under emergency conditions. In a financial crisis the time factor is often crucial. Decisions have to be taken under time pressure and in the absence of sufficient information. As the crisis has proven, already national supervisors have been overstrained too often by this challenge. The complexity of the European supervisory system with its multiple filters will meet even more difficulties to react appropriately in cases of emergency. The new system remains therefore far below what is required.

In addition, the impact of supervision depends very much on the quality of the supervisory institutions. There is a need to supervise supervisors. There are many cases in the past, where regulation existed, but supervisors did not implement it. One of the most prominent cases is the Madoff scandal[16]. Although there have been all in all 19 complaints since 1999 about Madoff, among them a report entitled: "*The biggest Hedge Fund in the world is a fraud*" the US supervisors from the *SEC* (*Security and Exchange Commission*) did not seriously go after these hints.

The Madoff case is only the tip of the iceberg. Less spectacular for instance is the case of the German secretary of State in the finance ministry,[17] Jörg Asmussen. He recommended in an article in 2006 that the ministry should "*contain itself* with *regard to the supervision of current ABS products."*[18] He was at the same time member of the administrative council of the German supervisory authority BAFIN and of the board of the IKB, the first German bank to collapse in the crisis.[19] Unlike Madoff, Asmussen is still in office.

But even if supervisors are working properly there is still the problem, that there is a permanent lack of

Box 4:

Voting procedures in the Council

The EU Council – the assembly of the governments of the member states – is the most powerful institution of the EU. Initially it was functioning on the basis of consensus. This means that de facto each member state disposed of veto power. Theoretically, the veto has been abolished with the Lisbon Treaty. It is now possible to decide according to a triple majority, which has to meet the following criteria:

- 72% of the votes (whereby member state have different voting power. Malta, as the smallest has three votes, Germany as the biggest 29) and
- majority of member states, and
- the majority must represent at least 62% of the European population.

From 2014 onward (with a transition period up to 2017) the principle of double majority will be introduced, i.e. 55% of member states votes and representing 65% of the population.

In spite of the new rules there is a kind of gentlemen's agreement, according to which there should be no majority vote if vital interests of a member state are concerned.

(Rittberger 2007:3)

[16] Madoff, head of several Hedge Funds and well known as a philanthropist went bankrupt in 2008. Investors in Madoff's funds lost 60 bn. USD. In 2009 he was sentenced to 150 years of prison for having built up a fraudulent Ponzi scheme over many years.

[17] An equivalent to a deputy minister.

18 ABS = Asset Backed Securities. Belong to the class of toxic assets.

19 Sueddeutsche.de 20.10.2008. http://www.sueddeutsche.de/wirtschaft/joerg-asmussen-bankaufseher-warb-fuer-lasche-bankaufsicht-1.520306

resources. Unless supervision is endowed with sufficient resources, the best rules will make little effect.

4.2. Regulating Credit Rating Agencies

As a result of the expansion and increasing complexity of finance in the last decades, *Credit Rating Agencies* (*CRAs)* became more and more important. Their ratings have a tremendous influence, because market participants have to rely on them. Therefore CRAs can not only decide about the future of a financial product, a bank or a fund, but on the destiny of an entire country, as could be seen again recently in the Greek crisis. Furthermore, they bear a considerable responsibility for the crash, because they gave positive ratings to toxic assets such as *Credit Default Swaps* (*CDS*), which were one of the major triggers of the crisis.

The failure of the CRAs in the present crisis is not new. Also in former crises, for instance the Mexican crisis in 1994, the Asian crisis 1997/8, or the collapse of Argentina in 2001 they had completely failed. Nevertheless they are hardly regulated. This is also the case for the EU. The preamble of the EU directive explicitly asserts: "*Most Member States do not regulate the activities of credit rating agencies.*" (EU 2009a:2)

The main problem with CRAs is the procyclicality of their ratings. Their models are based on the same theory of efficiency and self-regulatory capacity of markets and the rational behaviour of speculators as the neo-liberal mainstream. They share their basic values and use the same mathematical models and the same computer programmes.

In addition, they make profits by advising the firms whose products they are going to rate how to design products to reach a good rating. This constitutes a conflict of interest which may bias the rating and contribute to financial instability.

Furthermore the business is highly concentrated. Three firms – *Fitch*, *Moody's* and *Standard & Poor* form an oligopolistic dominance of the global market.

4.2.1. The EU proposal

The directive adopted in July 2009. Its core elements are:

- registration and certification,
- transparency and information disclosure,
- quality of ratings,
- avoiding conflict of interests.

The new regulation is based on the code of conduct of the *IOSCO* (International Organization of Securities Commissions). Whereas the IOSCO standards are on a volunteer basis, the directive is legally binding and enforceable.

According to the draft directive each rating agency, which is active in the EU, needs to be registered. European firms are obliged to purchase their ratings only with registered CRAs. As all the relevant CRAs are based outside the EU there is a procedure to certificate them. Registration and certification are done by the nation supervisory authorities. If ratings are active in several member countries a so called *college of supervisors* has to be established. Ratings from outside the EU are only allowed, if these agencies have a subsidiary in at least one member state, which guarantees, that the EU requirements are met. Furthermore, ratings from third countries are only accepted if the respective home country is regulating CRAs.

The registered and certified agencies have to disclose the methodology of their ratings to the public. They also have to keep record on their activities and make them accessible to the public. Thus, the quality of the ratings can be tracked over time.

They are also obliged to guarantee high quality of their ratings and to keep pace with progress in methodology and technology. Their personnel need to have the appropriate skills.

The strongest measure is the regulation on conflicts of interest. Article 6,1 of the directive stipulates: "*A credit rating agency shall take necessary steps to ensure that the issuing of a credit rating is not affected by any existing or potential conflict of interest or business relationship involving the credit rating agency issuing the credit rating, its managers, rating analysts, employees, any other natural person whose services are placed at the disposal or under the control of the credit rating agency, or any person directly or indirectly linked to it by control.*" CRAs should also have a system of rotation of personnel in order to prevent that undue relations occur between agency and client over time.

4.2.2. A step in the right direction, but leaving the main problems unsolved

All in all, these measures are not wrong. But they are not going far enough to address the major problems, in particular the procyclicality of ratings. Compared to the US regulation of ratings, which establishes a liability of the CRAs for their ratings the European directive is clearly weaker.

The other basic problem, that the relevant agencies are based outside the EU, remains unsolved. The proposal to establish a European rating agency as a public entity has been relegated to a study or report to be prepared in the future.

4.3. Regulating Alternative Fund Managers (AIFM)

This law project with the slightly opaque name *Directive on Alternative Investment Fund Managers* (EU 2009c) refers to the regulation of Hedge Funds, Private Equity Funds, real estate funds (REITS – Real Estate Investment Rust Funds) commodity funds and infrastructure funds.

This is a special class of funds which clearly differs from other institutional investors like public or retail investment funds, pension funds, endowments, sovereign wealth funds or assets held on own account by banks, insurance or reinsurance.

At first glance it seems strange that the regulation is designed for the managers of AIFs and not for the funds as such. But as most AIFMs, which operate in the EU have their legal headquarters outside the Union - in the US or in offshore centres and fiscal paradises they would not be accessible for regulation. On the other hand, many AIFs operate in the EU. In London, for instance operate 80% of all Hedge Funds in the world.

Hedge Funds use all kind of financial assets, Private Equity Funds entire companies or shares. Real estate, commodity and infrastructure funds operate, as the name indicates with commodities, real estate and infrastructure, or with respective derivatives, such as commodity futures. All in all this category of funds has assets of two trillion Euro under management (EU 2009c:2).

The business models of Alternative Investment Funds (AIFs) have the following in common (see Wahl 2008):

- they take higher risks than other market actors, with the expectation to gain higher profits,
- they use high rates of leverage

- the minimum deposit is high, in many cases one million USD and above,
- their clients are other institutional investors or rich individuals,
- they are intransparent,
- there is no or only a minimum of regulation
- their legal headquarter is very often in an offshore banking centre or fiscal paradise, although the management and administration might work in one of the big financial places

For all these reasons it would be more appropriate to call the AIFs *speculation funds*. They are built as pure cash machines and have no positive macroeconomic effect. Before the crash they were sometimes defended against critical views, with the argument, that they take risks, that others don't take. This is true, but it is at the same time the problem. It is just because they take extraordinary risks that they are a threat to financial stability.

Private Equity Funds have an additional characteristic: they serve as a conveyor belt for the shareholder value orientation from the financial sector to the real economy. After having bailed-out a production or service company with the help of leveraged credit they reduce costs through lowering social, labour and environmental standard, neglecting long term interests such as productivity, innovation and market shares and transferring the debt burden to the company. After three to five years they resell the company. The former German Vice-Chancellor, Müntefering, has called them "*locusts*". Like these animals they devour a place and then continuer their way to the next one.

The speculation of commodity funds on commodity derivates is not only a financial issue. They create speculative bubbles and destabilize the markets. Their contribution had lead to a doubling of food prices in man developing countries with the result that many poor could not afford their daily bread any longer. The number of people suffering from hunger went up by 100 million in 2009.

4.3.1. The EU proposal

The EU has realised all this. In the first part of the draft we can read that there is:

- *"Direct exposure of systemically important banks to the AIFM sector*
- *Pro-cyclical impact of herding and risk concentrations in particular market segments ...*
- *Weakness in internal risk management*
- *Inadequate investor disclosures …*
- *Conflicts of interest and failures in fund governance, in particular with respect to remuneration, valuation and administration ...*
- *Impact of dynamic trading and short selling techniques on market functioning*
- *Potential for market abuse*
- *Lack of transparency when building stakes in listed companies*
- *Potential for misalignment of incentives in management of portfolio companies, in particular in relation to the use of debt financing"* (EU 2009c:2f)

The EU also recognizes "*that some of the risks associated with AIFM have been underestimated and are not sufficiently addressed by current rules*" and concludes that "*individual and collective activities of large AIFM, particularly those employing high levels of leverage, amplify market movements and have contri-*

buted to the ongoing instability of financial markets across the European Union.“ (ibid.)

The EU acknowledges furthermore, that particularly Hedge Funds have contributed to asset price inflation and the rapid growth of markets with toxic assets. Furthermore AIFs „*were implicated in the commodity price bubbles that developed in late 2007.“* (ibid). The analysis of the EU on the impact of AIFs is not far from what many critiques in civil society and from heterodox economist had said in the past.

But how does the draft of the directive look like?

a. First of all AIFMs would need an authorization if they want to operate in the EU. The authorization is granted by the respective national authority on the basis of a detailed procedure fixed in the directive. There is an exemption: AIFs with less than 100 million Euro assets under management or AIFs up to 50 million Euro assets, which do not use leverage. According to the directive this would mean that the legislation would capture only 30% of the managers but 90% of the assets.

b. There is a “*third countries clause*”. In order to avoid circumvention of the directive by delegating AIF activities to person outside the EU, this is only allowed if
   - the third country has the same standards for regulation as the EU and
   - is willing to pass information, which is relevant for taxation;
   - the legally registered office remains in the EU.

c. There are operational guidelines which oblige the managers to introduce a risk management system and to provide an appropriate liquidity management. An independent evaluation of the assets has to be done at least once a year.

d. Interest conflicts have to be made transparent and avoided. Therefore portfolio management and risk management have to be separated, as well as the administration and deposit of the assets.

e. There are minimum capital requirements for the administration of the funds: either 25% of the running costs of the previous year but at least 125.000 Euro. In case the assets go beyond 250 million Euro, the additional own resources have to be 0,02% of the excess amount.

f. Transparency towards investors and supervisors is required. An annual report has to be submitted which has to be audited by an independent auditor. The report should contain information about the remuneration of the managers, differentiated between fix and variable income. Investors should also be informed about the fund’s strategy, including leverage and risk management. The supervisory authority has to be informed regularly about the main activities, risk concentration and the markets where the AIF is operating. The supervisors shall have the right to limit leverage under certain circumstances.

g. Those AIFs which hold a share above 30% in a company have an obligation to inform the stakeholders, including employees, of the company about the basic lines of their strategy.

h. The supervisory authorities are given access to any document and records of telephone and data traffic. They can require information from any person and carry out on-site inspections without prior announcements.

From the point of view of the industry the directive is felt to be very strict. Compared to their comfortable situation before, for the first time they have not only to comply with quite a lot of new requirements, but some of these might infringe some elements of their business model. If, for instance, investors have more

knowledge about the risks, some of them might refrain from investing. If the supervisors realise, that leverage is too high, they can intervene. If a Private Equity Fund has to disclose its strategy, trade unions can develop a strategy of their own more easily. All in all, the directive would increase the costs for AIFs, reduce their risk appetite and their profits. The *London Times* therefore summarizes the feelings of the City as follows: "*Hedge fund directive strikes blow at City*."[20]

Consequently, it is not surprising that the AIF's lobby is fighting the directive heavily. The UK government is on their side. As already mentioned above, 80% of the Hedge Funds worldwide are operating in London. The final decision over the directive has been postponed twice, and the UK government tries to water down the regulation. The final decision is now expected to be taken in October 2010. This could also mean that in final compromise the regulation will be further watered down.

4.3.2. Deeply flawed

Independently from that, already the present draft has a significant weakness from a macro-economic point of view: the substance of the business model is not questioned. Of course, systemic stability could be increased to a certain extent, under the condition that supervisors play their role. But this requires the necessary resources, in particular enough personnel to monitor the AIFs and the political will to intervene. But risky speculation is still permitted, leverage will continue with official approval and the negative effects on the real economy will not be stopped. There is no macro-economic justification for such a business model at all. It only incurs risks, which are mitigated by a complex safety net, from which nobody knows whether it will hold in case of emergency. Therefore the best way to regulate AFIs is to ban them. The EU directive makes the casino perhaps a bit safer, in particular for gamblers, but it does not close it.

4.4. Regulating OTC derivatives

The draft "*Regulation on OTC derivatives, central counterparties and trade repositories"* as it is called officially has been presented September 15th 2010. Commissioner Barnier said in an interview: "*No financial market can afford to remain a Wild West territory. OTC derivatives have a big impact on the real economy: from mortgages to food prices. The absence of any regulatory framework for OTC derivatives contributed to the financial crisis and the tremendous consequences we are all suffering from.*" [21]

In fact, derivatives have played a fatal role in the financial crisis. In particular the so called *Collateral Debt Swaps* (CDS) turned out to be the infamous toxic assets. These derivatives belong to the class of credit certificates. Initially meant to be a kind of insurance against credit default, the CDS (and similar products) were intensively traded and used for speculation at large scale. The link between the initial credit and its derivatives was lost. The initial creditors took more and more risks, because with the help of the CDS they could transfer the risk to somebody else. In the end nobody knew how many CDS existed and where. In addition, CDS were used massively to speculate against the Euro in the Greek crisis.

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20 10 May 2010. http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article7121253.ece
[21] EU Observer, 16.09.2010. http://euobserver.com/19/30821.

Whereas only 10% of derivatives are standardizes and traded at an exchange the rest of 90% is traded *Over the Counter (OTC)*, i.e. bilaterally and without control or supervision. This is what Barnier meant, when he was speaking of "*Wild West*." The Bank for International Settlement (BIS) estimates the volume of OTC trade at 614,6 trillion[22] USD by the end of 2009 (BIS 2010). This is approximately ten times the global GDP.

From a macro-economic point of view derivatives are an ambiguous instrument. As long as they are used for insurance purposes (hedging) they can be useful and are applied at large scale since the 19th century. If trade is properly regulated, there is no threat to stability either. However, in the course of financialisation in the last decades, they have become more and more detached from real economy and were turned into tools of speculation.

4.4.1. The EU proposal

The EU directive is consistent with a similar regulation in the US reform package. This is in so far positive, as it reduces the possibilities of regulatory arbitrage. The US and the EU are the biggest markets for OTC trading and a regulation there captures most of the business.

The basic idea of the regulation is to establish a *central counterparty* (CCP) for all trade with derivatives.[23] This CCP would function like a marketplace or an exchange. Each seller of derivatives would have to sell its product to the CCP and each buyer would have to buy it from the CCP. Both would have to pay for the margins of the CCP. The CCP would also be responsible for the clearing of the deals. For derivatives that are not eligible for CCP clearing, requirements like margin and collateral would be in force.

National authorities will authorize central counterparties according to the rules of the regulation. The CCP has to operate with high standards of transparency, reporting, risk management, liquidity and capital requirements. Also strict supervision is envisaged. In addition a trade repository will be established, i.e. an archive where all deals are registered. Supervisors have full access to all information in the trade register, and aggregate position information will be published.

In line with the US reform act, the EU regulation also grants exemptions to so called non-financial counterparties, which means companies who use derivatives to hedge their business risks. A typical example is an airline company which hedges against price volatility of kerosene with the help of futures. There will be two thresholds for these non-financials, one exempting them from the information requirement and one exempting them the clearing obligation.

As a provision for future crisis a mutual fund has to be established to which the clients of the CCP have to contribute. In case of default, losses will be paid from the fund.

The draft also provides for a regulation of the derivatives themselves in certain cases. The *European Securities and Markets Authority* - ESMA (see chapter 4.1.1.) is entitled to decide on the approval of a class of derivatives, before they can be traded at the CCP. Article 4.3. of the directive says: "*ESMA shall base its decision on the following criteria:*

(a) reduction of systemic risk in the financial system;

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23 There may be exceptions in those cases, where non-financial firms are only hedging risks., as long as this is not a systemic risk. An example would be if an airline is hedging against price risks of kerosene.

(b) the liquidity of contracts;

(c) availability of pricing information;

(d) ability of the CCP to handle the volume of contracts;

(e) level of client protection provided by the CCP." (EU 2010:24)

This would be quite a strong instrument and it will be interesting to see, whether it will survive the further law making process.

Another far reaching rule can be found in Article 43 which deals with collateral requirements: *„The CCP shall only accept highly liquid collateral with minimal credit and market risk."* (EU 2010:48). If strictly implemented, this would mean that the trade volume would shrink, because it is impossible to collateralise 614 trillion USD with the requirements of the directive.

Furthermore, the CCP has the right to reduce the value of an asset (so called haircut). *"It shall apply adequate haircuts to asset values that reflect the potential for their value to decline over the interval between their last revaluation and the time by which they can reasonably be assumed to be liquidated. It shall take into account the liquidity risk following the default of a market participant and the concentration risk on certain assets that may result in establishing the acceptable collateral and the relevant haircuts."* (ibid).

4.4.2. A step towards stability, but many details left open

All in all, the proposal is a step towards more stability. It deals with a central stability risk and will have impact on the entire sector. It might also contribute to shrink the volume of derivatives trade.

However, certain things remain still vague, as the requirements for remaining bilateral trades, the rules for extreme market conditions (as for example excessive speculation), or the rules on concentration limits. It should be clear that aggregate position limits should be enforced. Furthermore, the exemption for non-financial counterparties and the thresholds need to be narrowly defined and limited. Non-financials also can trade in a speculative way, which has to be taken into account. However, among all other proposals under discussion this is one with real impact.

The influence of the new Commissioner, Michel Barnier (in Office since 2009), is obvious. Unlike his predecessor, Charlie McCreevy, [24] who was a strong believer in the neo-liberal dogmas, Barnier is rooted in the traditions of French etatist culture and more open to regulation.

Nevertheless, even if he succeeds to get the proposal through without losing to much of its substance, it can only be a first step on the way to a proper regulation of derivatives. Speculation may be curbed slightly, but most of it won't disappear. Issues beyond stability, such as the impact of the derivative markets on the real economy, on distribution, labour, wages etc. are left out.

[24] After he left office McCreevy is working for a bank and for Ryan Air.

4.5. Regulating Short Selling and Credit Default Swaps

Together with the directive on OTC derivatives the Commission presented a draft regulation on *Short Selling and certain aspects of Credit Default Swaps* on the 15th of September 2010 (EU 2010b).

Short selling is a technique to speculate on falling asset prices. Behind “normal” speculation is the expectation that a price will go up in the future. The speculator buys an asset and some time later, if the expectation comes true, sells it at the new and higher price. Speculating on falling prices instead works as follows: a seller does not yet own an asset, but promises by contract (normally a future) to sell it at a later date, but at the present price. Parallel he has a contract or an agreement to borrow, which guarantees delivery of the asset at the market price at the later date. If his expectation comes true and the price goes down, he gets the asset from his second contract or lender at market price and sells it according to his first contract at the old and higher price.

A subclass of short selling is naked or uncovered short selling. In that case, the speculator has no security for the asset at the moment when he is entering the contract.

In theory, short selling would have two advantages:

- It would contribute to price efficiency. If investors believe, that an asset is over-valuated short selling would “get the price right”.
- It would act against the building up of a bubble (so called *bull market*). If speculation on rising prices becomes a trend, a bubble occurs. In that case short selling would have a “counter cyclical” effect and exert pressure for sinking prices, which, in case of success leads to *bear markets*. Speculation to combat speculation.[25]

This simplistic model ignores the reality of overshooting which is inherent to financial markets (Schulmeister 2009). Like the upward trend leads to an overshooting, because many investors want to benefit from the trend (“herd behaviour”) the same can happen in the downward direction. The overshooting then leads to an erosion of prices, increases volatility and threatens stability. In the words of the Commission: “*For example in extreme market conditions there is a risk that short selling can lead to an excessive downward spiral in prices leading to a disorderly market and possible systemic risks*.“ (EU 2010b: 2)

Both phenomena are detached from the real economy. Recently the effect was particularly pertinent in the Greek crisis, when prices for Greek government bonds were falling far below the real debt situation of the country. The background was panic of investors, amplified by herd behaviour. At the same time, the prices for *Credit Default Swaps (see chapter 4.4.)*, i.e. insurances against default of the Greek bonds were skyrocketing for the same reason.

The example makes clear, why the Commission has made this proposal on these two instruments – short selling and CDS – which at first glance seem to have nothing to do with each other. The proposal is right to treat the excessive “going long” (i.e. buying”) with CDS as the reverse side of short selling and to include it into its regulation: “*Buying credit default swaps without having a long position in underlying sovereign debt can be, economically speaking, equivalent to taking a short position on the underlying debt instrument.”* (ibid. 14). The regulation of

[25] The price efficiency and anti-bubble argument serves to legitimise short selling in principle. However, if speculation in bull markets would be curbed from the beginning, for instance through transaction taxes, counter speculation would not be needed neither.

CDS is very much inspired by the experience with the speculation against the Euro.

Naked short selling has an additional risk: if the speculative expectation does not come true and prices do not go down, or go even up, the short seller has a problem. He will make a loss or might even default. This happened for instance in November 2008 when the German car company *Porsche* was making a naked short selling operation at large scale with Volkswagen shares, in order to take over Volkswagen. The speculation failed. Volkswagen shares went up. The result was that Volkswagen could take over Porsche in the end.

Given all these risks, several governments had already banned short selling temporarily in 2008 and 2009, among them the US, France, the UK and Germany. In May 2010 Germany has banned short selling until March 2011.

4.5.1. The proposal of the EU on short selling and CDS

The core of the EU proposal is to give supervisors the right to ban short selling and the trade with CDS temporarily. Supervisors will be enabled *"to impose restrictions on short selling and credit default swap transactions or limit natural and legal persons from entering into derivative transactions*." (ibid: 9).

As for the scope of the proposal, all financial instruments will be covered.

Supervisory authorities have the right to intervene. if they realise that a market participant, regardless whether there will be automatic prohibition of short selling or not, a *circuit breaker* will start, if there is a significant fall in asset prices. The threshold for triggering of the circuit breaker is a decline of 10% or more of an asset during a trading day. However, the supervisors are only entitled to interrupt trading for one trading-day.

Naked or uncovered short selling in the full sense is de facto banned. Because short selling is only allowed if the seller has:

- *„borrowed the share or sovereign debt instrument; ...*
- *entered into an agreement to borrow the share or sovereign debt instrument;…*
- *an arrangement with a third party under which that third party has confirmed that the share or sovereign debt instrument has been located and reserved for lending for the natural or legal person so that settlement can be effected when it is due."* (EU 2010b:25)

In order to enable the supervisors to fulfil their role transparency, information and reporting are required at several levels:

- the trading place, for instance an exchange, has to publish on a day to day basis a summary of orders for short selling;
- individual traders have to disclose short positions when they exceed the threshold of 0,2% of the assets of the company concerned.

If a short seller is not able to deliver the contracted assets within four days, measures are automatically taken for the trading place or the Central Counterpart (see chapter 4.4.) to buy-in, in order to ensure delivery for settlement.

Furthermore, short sellers can be obliged to disclose their positions to the public, if the position reaches or falls below a certain threshold fixed by the supervisors under the condition that there is a serious threat to stability in one or more member countries and if publication is necessary to address the threat.

The Commissions proposal is used to give particular competences to the new *European Securities and Markets Authority* (ESMA) under the condition that there are cross border implications and the national authority has "*not adequately addressed*

the threat." In such a case, ESMA has the same rights as a national authority. The measures taken by ESMA would even override the competences of the respective national supervisors. ESMA is furthermore entitled to carry out inquiries in a national state and publish its findings.

In addition, the proposal tries to enhance cooperation between national supervisors. Article 31 stipulates, that a national supervisor has to make an on-site inspection or an investigation if requested by the authority of another country. The requesting supervisors can be allowed to participate in the undertaking or even carry it out themselves. ESMA will coordinate the activities.

4.5.2. A mixed blessing

The draft on short selling and CDS is relatively strict compared to other EU proposals. It has been developed under the impression of the Greek crisis and gives supervisors an arm against some of the most dangerous practices and instruments in financial markets. It would also introduce a relatively strong supranational element into supervision. In that sense the regulation is a step forward.

There are, however, reverse sides: as the German regulation on short selling is stronger, because it is banning speculation on falling prices not only temporarily and in cases of threats to stability, a harmonisation at the level of the EU proposal would be a downward adaptation, another infamous rat race to lower standards. The German ban has been criticised, because it would create a different level playing field. The EU proposal would have now the chance to create an equal level playing field – however, adapted to the higher standards of the Germans.

Also a stricter regulation would be wishful for CDS. Although certification of credits might be a useful instrument as long as it is not used for speculation, the draft proposal does not take into consideration speculation. Instead, it accepts CDS irrespective of their purpose. The Commission might argue, that a respective provision is in the new draft agreement Basle III on capital requirements (see chapter 4.7.). This is true, but first: Basle III is not yet implemented and might be subject to changes. Second: Basle III is only applicable for banks. But Hedge Funds and other leveraged institutions also trade with CDS.

Therefore the Commissions proposal should be amended both with respect to short selling and to trading with CDS.

4.6. Making the finance sector pay for the costs of the crisis

Whereas the proposals under points 4.1. to 4.5. have been already presented In form of a draft directive, a set of ideas has also been announced or is under discussion, but not yet presented as draft directive. Major public attention has been given to the idea of a Financial Transaction Tax (FTT). The proposal is discussed in the EU (see next chapter). But the Commission also envisages a broader framework for crisis management, which would include a resolution fund, financed through a bank levy, as well as a deposit guarantee scheme (EU 2010c).

4.6.1. The discussion on the FTT

The costs of the crisis are enormous. The IMF estimates the expenditures of governments for stimulus programmes to mitigate the consequences on the real economy lie at 3,5% of global GDP (IMF 2009:vii). Together with the rescue packages to save the banks, governments have spent approx. 3,5 trillion USD globally to combat the crisis.

As the financial sector bears the main responsibility for the crisis, the question arises, who will carry the costs. There are strong demands in the public to make the banks pay, in particular as some of those, which have survived the crisis are making big profits again. Under this pressure the G20 summit in Pittsburgh had mandated the IMF to prepare a report on options "*as to how the financial sector could make a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system*." (Pittsburgh Summit Leader's Declaration). But the G20 summit in Toronto 2010 rejected the FTT. In particular Canada, the UK and the US, but also India were against the FTT. The bank lobby is fighting the FTT vehemently.

Independently from that, several countries, among them the US, France and Germany had already rather early envisaged a bank levy. At the same time civil society in Europe and North America was mobilising for a Financial Transaction Tax (FTT).

In the EU the FTT got support by the governments of Austria, Belgium, France, Germany and Greece. The president of the EU Commission, Barroso was also speaking out in favour of a FTT.

On the other hand, the UK, Sweden and the Netherlands are against the FTT. A "non paper" written by the staff of the directory for the Internal Market, is however rather critical towards the FTT, using arguments which had been rebutted by the proponents of the tax several times in the past (Jetin/Denys 2005).

Box 5. FTT, Bank Levy and FAT

The FTT has a double capacity:

- a big potential for revenues. A tax rate of just 0,1% would yield globally 734,8 billion USD a year in a scenario where there would be a medium reduction of transaction volumes resulting from the tax. At 0,1%, for Europe the figure would be 321,3 bn. USD. Even with a tax rate of 0,01% the revenues would still be considerable (Schulmeister 2009).
- But in addition the FTT would have a regulatory effect. It would reduce speculation, in particular electronic high speed transactions, which today make already 60% of all transactions at the New York Stock Exchange, would become unprofitable.

The bank levy instead would have no regulatory impact. Its revenues would range from 1,4 bn. USD in the German concept to 9 bn. USD in the initial US proposal. The Obama administration had to sacrifice its bank levy in order to get a compromise for its law package.

The IMF has proposed a third instrument, the Financial Activities Tax – FAT (IMF 2010). The FAT would tax the profits and the remuneration of banks. The IMF favours in his report a combination of Bank Levy and FAT.

The German government has considered implementing the FTT in the Euro-zone, if it should be impossible to reach a consensus at EU level. But Luxemburg has already announced that they would not accept this. The issue remains on the agenda of the ECOFIN in autumn 2010, but the chances to reach a positive result are minimal.

If the EU fails to make the financial sector pay a substantial share of costs for the crisis, which it has triggered, this will not only perpetuate the problem of moral hazard, i.e. the conviction of the finance sector that whatever they do, they will be rescued by the state, but will also reduce the acceptance of the EU among citizens further. The perception, that the entire crisis management had something deeply unjust, will be confirmed. According to the results of *Eurobarometer*, the regular European opinion poll, from August 2010, only 49% of the European citizens consider the EU membership of their respective country to be positive (Eurobarometer 2010:12).

4.6.2. Resolution fund and broader EU framework for crisis management

As for the bank levy, Commissioner Barnier has announced a proposal in May 2010 (EU 2010c). In the communication he sketches the guidelines for a directive, which aims at a broader mechanism for crisis management, among others a resolution fund financed by a bank levy. In this paper the Commission recognises that the financial sector has to contribute to the costs of the crisis: *Political support is growing for applying the so-called* ***"polluter pays" principle****, known from environmental policy, also in the financial sector so that those responsible for causing it will pay for the costs of any possible future financial crisis*." (ibid:3)

The most important elements of the proposal are:

- a resolution fund should be established,
- it should be funded through contributions ex ante from the banks,
- the Commission is not yet clear on the tax base and is considering different options such as assets, liabilities, profits and bonuses,
- the purpose of the resolution fund should be to finance prevention measures, but also to arrange for *haircuts*, early intervention and recovery measures, resolution, including bad banks and transfer of assets or liabilities to third parties, deposit guarantee schemes and finally procedures for liquidation.

Of course, the Commission considers a European resolution fund to be the ideal solution, but they are realistic: "*However, the Commission recognises that it would be very difficult to begin with the creation of an EU Resolution Fund in the absence of an integrated EU supervisory and crisis management framework."* (ibid:6) Barnier therefore suggests a network of national funds.

The proposal is still at a very vague stage, could however have some interesting potential.

4.7. Capital requirements and Basle III

Capital requirements are a fundamental element in the regulation of financial institutions. Therefore national regulations have been existing for many years. In the course of globalisation more harmonisation of the different became imperative. This is why in 1988 the *Basle Committee on Banking Supervision* adopted an accord (Basle I), which provided for common standards. The *Basle Committee* is attached to the *Bank for International Settlement (BIS)*, located in the Swiss town of Basle.[26] Its members are the representatives of central banks and supervisory authorities of the OECD countries. In 2006 a new agreement (Basle II) was adopted. Basle agreements are recommendations and legally not binding, but there is a strong de facto pressure to integrate them into national legislation. Common standards increase mutual confidence and thus reduce capital costs.

Basle II was very much inspired by the neo-liberal thinking. It was lowering capital requirements and giving more flexibility to the Banks. It introduced a complex system of risk measurement, which was left to the banks. Furthermore, Basle II was only dealing with risks at micro-economic level. The accords only cover banks, where as Hedge Funds, Private Equity Funds and other non-bank actors are not concerned. In 2006 the EU had taken over *Basle II* in two directives (2006/48/EC and 2006/49/EC). The directives entered into force in January 2007.

As the crisis has shown, *Basle II* has not met the expectations. At the contrary, it contributed to undue risk taking and was weakening the resilience of the system. This is why there are negotiations for a Basle III agreement. The result will be presented to

[26] NB: Switzerland is not member of the EU

the G20 summit in Seoul in November 2010. The EU has announced to take over the Basle III as soon as a definitive agreement has been reached.

Basle III will not replace Basle II. Most elements of the former agreement will continue to be in place, whereas the core figures for capital requirements will be increased.

The main elements of the new agreement have been communicated by the Basle Committee in September 2010 (Basle Committee 2010). According to that, the new requirements should be:

- the core capital will be increased from 2% to 4.5% of total capital;
- a *capital conservation buffer* of 2,5% will be introduced, bringing the requirements all in all to 7%. Banks are allowed to draw on this buffer to absorb losses during periods of financial and economic stress. While using this buffer, there are restrictions to pay dividends;
- as a third component countercyclical buffer ranging from 0 - 2,5% according to the conjuncture should be implemented. This buffer will only be in effect when there is excess credit growth that is resulting in a wide system of built up risk. The obligation to accumulate the countercyclical buffer will absorb capital in a boom phase and work as a break to build up bubbles;
- For systemically important banks additional requirements beyond these standards have been announced;
- A leverage ratio of 3% has also been agreed upon. This means that leverage is limited to 33 times the banks core capital;
- Also a liquidity ratio is envisaged, which should allow a bank to meet its short term obligations. A figure has not been set;
- Finally, an essential issue is the definition of capital. According to the new agreement only own and liquid assets of the bank, i.e. equity capital and disclosed reserves, will be accepted as core capital, or *common equity*, as it is called in the insider jargon. This improves the quality of the core capital.

The implementation of Basle III shall start on the 1st January 2013. This means that the EU will have to pass the respective legislation at the latest in 2012. This would give banks the time to accumulate the additional capital. However, implementation will only be step by step and the transition period to full implementation will last until 2018.

The agreement is reversing the trend to lower standards as it was the case with Basle II, and stability will increase with higher standards. The question is, however, whether the new requirements are sufficient. Initially the secretariat had proposed higher levels (above 10%), but this position could not prevail in the negotiations. Also the long transition period seems to be very complaisant vis à vis the financial industry.

Box 6: The US reform bill (Frank-Dodd act)

In June 2010 the US adopted a reform package. The bill was heavily opposed by the lobby of Wall Street, which, according to finance minister Geithner, spent 1,4 billion US per day to water down the draft. In the light of the precarious balance of power in the US parliament and the fundamentalist opposition of the Republicans, a lot of compromises, exceptions and carve-outs had to be accepted. For instance the bank levy was kicked out in the last minute, or the "Volcker rule" (see below) was carved out by allowing banks to establish their own Hedge Funds, and on remuneration only non binding recommendations passed.

But in spite of all its shortcomings, the US bill is an important step on the way to regain political control over the financial markets. Americans for Financial Reforms, a broad civil society alliance including trade unions, NGOs and social movements "*believes this bill is very significant and goes far toward achieving [our] goals. It is also a basis on which we can build for greater reform in the future*." (AFR 2010)

The most important elements of the US package are:

- higher capital, leverage and liquidity standards on the biggest and riskiest firms;
- the integration of large "shadow banks" like AIG and the mortgage financers into the general system of oversight;
- the "Volcker Rule", which makes a separation between investment banking and normal lending. Under this rule banks are not allowed to make risky proprietary trade for their, i.e. speculation at their own accounts;
- banks will have to hold capital in reserve that reflects all the off-balance sheet debt they could potentially be responsible for in the event of a crisis;
- an insolvency procedure so that the government can safely shut down not just depository banks, but shadow banks like AIG or the conglomerates that own banks (like Citigroup);
- most trade in derivatives will have to pass through a third party clearing house. All financial firms (including hedge funds etc.) will be required to submit standardized swaps to clearinghouses and post margin to back their operations.
- Credit Ratings Agencies will be under the control of the supervisors for the first time. The supervisor has the right to write rules, to levy fines and to examine rating agency operations. CRAs have to disclose the data and methodologies used in their ratings, as well as ratings performance. They can be deregistered if they providing bad ratings over time. They are prohibited from advising an issuer and rating that issuer's securities. The bill establishes a liability for the quality of ratings, which opens up the option for compensation;
- consumer protection. As much more US households than elsewhere are involved in one way or another in financial markets, these rules are very important. A special agency will be created (Consumer Financial Protection Bureau);
- Investor protection is improved;
- Improvement of the supervisory system by creating a "*council of regulators*" which will coordinate the institutions in charge with supervision.

5. Closing down the Casino or make it safer?

Taken together, the EU proposals will increase financial stability to a certain extent. If such a reform would have been proposed before 2007, one could have even been praising the Union for its efforts. However, if one takes the assessment of the de Larosière report – and so many others – serious, that the crisis is "*the most serious and disruptive financial crisis since 1929,"* there is a dramatic discrepancy between the scale, profoundness and quality of the crisis and the response of the EU.

The biggest shortcoming is the reduction of the problems to financial stability. Of course, financial stability is a public good which has to be promoted, developed, refined and preserved in an ongoing process. But the crisis has taught, that the financial system was not only instable in itself, but threatening the entire economy through its dominant role, its speculative practices and underlying structural problems like unequal distribution and the global imbalances.

Therefore, reforms, which are at the level of the challenges must break the dominance of finance over the real economy, must shrink the whole sector to an extent that it is not able to threaten the entire economy any more, and must address the negative distributive effects of financialisation and the global imbalances as well as the imbalances inside the EU. Governments must gain back full control over financial markets.

The basic questions, which came up with the crisis, are not addressed, such as: which kind of financial system do we need in order to cope with the challenges of the 21st century? At whose service and in whose interest should the financial system work? The EU regulation falls short of all these requirements. The EU approach follows the same logic as if in energy policies one would only look on how nuclear power plants can be made safer, whereas the question of alternative energy supply is not asked at all. Or, as the UN Conference on Trade and Development (UNCTAD) put it: "*Nothing short of closing down the big casino will provide a lasting solution.*" (UNCTAD 2009: 60).

But even if one takes the EU's approach to look only at stability issues, there are still many shortcomings:

- most regulations, which go into the right direction, are too weak. There are loopholes and too many exceptions. In general there is too much complaisance for the financial industry;
- speculation, the biggest inherent risk factor for systemic instability is only mitigated, but still accepted as the main business model;
- there is no provision to the problem of "*too big to fail*" and the moral hazard attached to it;
- there is no firewall between lending and speculation, as the "Volcker rule" is stipulating in the US reform bill;
- financial industry is not made to contribute adequately to the costs of the crisis. Hence, here too there is a moral hazard problem;
- the ECB, which has played a very ambiguous role before and during the crisis, is completely left out from the regulatory efforts. There is need to amend its statutes and to include employment and sustainable growth into its mandate;

- the issue of offshore centres and fiscal paradises is not addressed. They are not only loopholes for illegal capital flight but facilitate also regulatory arbitrage. Although the EU would be well placed to demonstrate leadership and to close these jurisdictions within its borders.

Today, the world is confronted with historically exceptional challenges, such as climate change, hunger, poverty and increasing shortage of important raw materials. Under these circumstances, finance has to meet qualitatively new requirements. The world needs financial markets at the service of sustainable development, of social equity at global level for the coming decades. Tremendous efforts need to be financed. We cannot afford another crisis like the present one, and we cannot afford a financial system, which serves at first place the profit interests of a tiny minority. A new paradigm is needed with regard to finance. In the light of these realities, the EU regulation of finance is like fire fighting with buckets.

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