Internationale Politikanalyse
International Policy Analysis

Christian Kellermann

Europe's Leverage in Financial Market Regulation

The financial crisis that originated in the USA last summer has had major repercussions in Europe. In Germany as well as in other EU member states, news stories and scandals broke concerning billion-dollar bank writedowns as a result of loan defaults related to the US real estate market. The markets still have not settled down as reports of new losses continue to surface.

Calls for stronger regulation of financial markets and their actors have increased for about ten years ever since the Asian crisis sent shockwaves around the world. They have still not been heard and action is more imperative than ever. As of yet, the extent of the current credit crisis can not be estimated and central banks continue to be faced by an opaque network of shady credit constructions. National financial centres can do little in this storm. The European Union has greater leverage on account of its size and its weight in the international financial markets to work towards stricter regulations. The present crisis could therefore serve as a catalyst for tightening regulations in the EU itself, as well as global regulations. Continuing a policy of '*laissez faire*' and timid statements about greater transparency are certain to lead to yet another crisis.

Dr. Christian Kellermann works with the International Policy Analysis Unit of the Friedrich-Ebert-Stiftung in Berlin. Contact: Christian.Kellermann@fes.de

Drivers of the Subprime Crisis

In the last few years real estate markets and private consumption in the USA have goaded each other on to the extent that excessive indebtedness has reached dangerous levels. This indebtedness – both household and public – was financed by the enormous influx of foreign capital. About six months ago confidence waned in the sustainability of the debt-driven US consumer boom. Financial difficulties emerged in particular in the case of subprime mortgages, with repercussions for extremely complex credit chains that had come into being as a result of the securitisation and resale of credit risks through special purpose vehicles and their financial products. Subsequently, the uncertainty and intransparency of many banks' risk exposure in the subprime market led to a crisis of confidence in the interbank market resulting in massive liquidity bottlenecks. This problem could not be solved in a sustainable way, despite enormous cash infusions by central banks of the USA and the Eurozone. This is why the crisis of confidence in the financial markets spread, causing securities markets to plummet through the floor (see Kellermann 2007).

The full extent of the repercussions that the credit and financial crisis will have on the "real" economy – that is, manufacturing industry, consumers, and so on – are still difficult to gauge. Corrected growth forecasts have sent a clear message to the euro area: Germany in particular, which is heavily dependent on the US market, has to prepare itself for a drop in growth (Bun-

FRIEDRICH EBERT STIFTUNG

SEPTEMBER 2008

desbank 2007: 11). At this crucial point in time, Germany needs to exert its influence within the European Union to create a preventive regulatory framework in and by the EU.

Specifically European problems with regards to financial markets, as well as in other areas, consist in the difficulties of so-called 'positive' and 'negative' integration: On the one hand, a European financial market was created through the dismantling of national regulations ('negative integration'), while on the other hand, though not to the same extent, a pan-European regulatory framework was set up ('positive integration'), leading to gaps in supervision, inefficiencies and possibilities for legal regulatory arbitrage – the exploitation of various regulatory levels in the European member states – a process which is continuing.

Integration and Weight of European Financial Markets

Up until now, the negative integration of European financial markets has developed as follows. The creation of the European Single Market in 1993 linked freedom of capital movement and the aspiration to establish an integrated capital market in the EU. On the initiative of the EU Commission a comprehensive liberalisation of European financial markets has taken place by means of the *Financial Sector Action Plan* (FSAP) since 1995. In its wake, in 2004 the Markets in Financial Instruments Directive, the Directive on the Harmonisation of Transparency Requirements concerning the information obligations of security issuers, the Takeover Bids Directive and not least the Directive on Markets for Financial Services were concluded, while the International Financial Reporting Standards (IFRS – previously IAS) for listed companies were made binding (cf. EU Commission 2004). Other important steps in the direction of an increasingly integrated financial market include the introduction of the euro and the harmonisation of technical market requirements (Single Euro Payments Area – SEPA) (Schrooten 2005: 44).

Integration has proceeded furthest in the financial markets, which are most closely related to the single currency. These are followed, with diminishing levels of integration, by the bond markets, the stock markets and, least integrated of all, the credit markets (cf. Weber 2007). The main reason for this is the availability of information on various other national market conditions, but also different levels of regulation, above all in the area of bank supervision.

At the same time, we can discern a shift in the importance of different market segments. The European Commission's Financial Integration Monitor 2006 reveals the extent to which the importance of institutional investors (especially pension funds, life insurance companies and equity funds) has increased. Over the last ten years the latter have experienced a near fourfold increase in value and are worth €6.4trillion today. Investments in life insurance companies doubled between 1994 and 2004, while the sums managed by pension funds in the EU in 2004 were around €2.4trillion, an increase from €1.6trillion in 2002. In 2005, hedge funds were managing around 256billion dollars in Europe (around 21per cent of hedge fund capital worldwide), and the trend is upwards, with fund management mostly concentrated in London. Private equity funds in Europe have developed at a similar rate; in 2005 they were worth over €70billion, double the amount of the three previous years (SPE 2007: 40, 67f.). The EU's position in the global financial market is comparable with that of the USA. The EU share in global financial business varies by market sector between 20per cent and 40per cent (EU Commission 2006: 9–20).

The regulatory structure is inadequate with regard to both the level of integration and the size and importance of European financial markets. In the future, better regulation and supervisory instruments should ensure that the financial markets perform their tasks of allocatory efficiency and real diversification of risks instead of turning into mere fora for speculation that could potentially lead to the destabilisation of whole economies.

Better Rules for (European) Financial Markets

The aims of an integrated European financial market (efficiency, risk diversification, stability and the provision of liquidity) can be achieved only if an efficient European supervisory structure and adequate regulation of complex investment vehicles are developed and given the necessary support. This is made more difficult by the great profusion of innovative financial products and investment models whose inherent risk is difficult to assess even for the brokers dealing with them. To be sure, many of these so-called structured financial products also serve the purpose of avoiding existing regulatory regimes in traditional national markets. As a result risk has become dangerously opaque, and its extent will become clear only in case of a crisis (IMF 2008: 36). In order to overcome this central deficit in the regulatory structure of a financial market as large and integrated as the EU's, the following three proposals should be considered:

1. In the future *credit risks should only be allowed to be structured and resold* if a minimum proportion of the net economic interest is kept in the books of the issuing institution. This will prevent global credit chains from evading oversight and becoming linked off the balance sheets of the relevant parties. This measure is explicitly not a matter of restricting the sensible and efficient risk-sharing among more parties. The intention is merely that the assignment of risk is preserved and that transparency and consequently risk management is improved. The change to the EU Capital Requirements Directive recently proposed by Single Market Commissioner McCreevy points in the same direction: credit institutions ought to be able to invest in structured financial products only if their issuers retain at least 10per cent of the net economic interest in their own books. The new regulation is to be applied to all institutions active in the EU (EU and non-EU institutions) with effect from 1 January 2011 (EU Commission 2008a).

2. Apart from that, the *capital requirement rules must be tightened* in order to neutralise the extreme leverage effects of certain investment strategies. Here the starting point is in the first instance classical bank regulation. Stricter capital requirements would also have disciplinary effects on other investors, such as *private equity and hedge funds*. With the current provisions (Basel II Accord) on equity capital first steps have already been taken in this direction. However, in the face of still existing circumvention strategies these are not effective enough. More risky credits (for example, to *hedge funds*) should therefore be given a much higher weight in the process of credit conditioning than less risky credits. Comprehensive regulations for the different forms of investment should therefore be worked out. Lack of disclosure of portfolios by switching to unregulated *offshore* financial centres ought to be subject to a rigid penalty clause (SPE 2007: 25ff).
3. However, capital requirement rules tend to be pro-cyclical since in a credit boom the banks' equity base is expanded. In order to reduce *anti-cyclically* risky extremes in credit allocation in a boom period it would make sense to introduce a system of *minimum reserves in terms of financial and tangible assets*. This would mean that finance companies, in accordance with their respective performance and risk exposure, would have to deposit minimum reserves with the European Central Bank. In the case of a worsening market situation the ECB could vary these reserve requirements anti-cyclically and so dampen incentives for speculation or panic reactions.

These measures should be implemented swiftly at the institutional level. The promise of financial actors to reform are as inadequate as referring to for a that are working on improving information exchange and a non-binding blacklist of particular practices such as the Financial Stability Forum (established at the Bank for International Settlements) or the *Hedge Fund Working Group*. This also applies to the new code of conduct presented in July by the Institute of International Finance (IIF) in response to the credit crisis. The 370 banks organised in the IIF are to implement the recommendations contained in the report *Market Best Practices* under the supervision of the IIF. The greater part of these recommendations comprise measures for the improvement of corporate governance, internal incentive structures, risk and liquidity management and balance sheet reform in relation to risk exposure, reorganisation of rating agencies and the creation of a *Market Monitoring Group* (IIF 2008a). As usual, the big banks' lobby is using these 'codes of conduct' to pursue the strategy of forestalling stricter state regulation. However, such a code can never be an effective substitute for universal regulation. In addition, the IIF code of conduct is unsatisfactory in many ways. As expected, the code contains general assent to a supervisory authority for rating agencies in order to prevent conflicts of interest, and to supervise the quality of rating methods and the transparency of the agency itself. That is in line with a proposal of the EU Commission (EU Commission 2008b). And in fact, credit rating agencies have had a pro-cyclical effect in the recent crises, that is, they have made things worse. On the other hand, this 'scapegoating' on the part of the bank lobby and the EU Commission distracts from the real problems in the credit business and the interbank market.[1]

The coordination of supervisory authorities for the securities, insurance and banking business envisaged in the EU's so-called Lamfalussy Process represents a possible basis for a developed system of supervisory authorities. These authorities would cover the full range of financial services that in the medium term should take the form of a *European financial market supervisory authority*. This kind of arrangement should be built on a harmonised regime of national supervisory systems whose national basis, despite attempts of coordination, is no longer adequate for the cross-border activities of financial market actors. This authority would be the institutional guarantor of the proper issuing of the 'European banking passport'[2] in the case of the authorisation of financial products. It would also serve as a body exercising continuous control over EU regulations on financial products that underlie the pass. The European banking passport could also be used to standardise financial products in order to simplify public control and counter the systemic deficiencies of rating agencies.

Regional Regulation as a Global Competitive Factor

Further development of the 'positive integration' of European financial markets by means of a set of short- to medium-term measures is urgent, given the loopholes and weaknesses of the system. The aim of such regulation must be to increase stability, accountability and transparency. The EU Commission can play a central role in development and implementation, both within and outside Europe. The European Single Market, meanwhile, is like a "tanker" on the world financial markets, which gives European actors great weight in international negotiations. Moreover, the EU should set a good example: a European financial market directive that lays down binding rules concerning balance sheets and reporting obligations, the regulation of the rating sector and the conditions for institutional investors would represent an important step towards more stable financial mar-

1 This was shown among other things by the hostile response to the proposals on regulation of the banking market presented at the end of March by the Committee of European Bank Supervisors (CEBS). Given that the Basel II regulations do not provide financial institutions with sufficient protection the interbank market should be reined in by tightening capital requirements (CEBS 2008).

2 Directive 2003/71/EC regulates the quotation procedure in the EU for securities offered in several EU member states. If a security receives authorisation from the national supervisory authority of a member state this needs to be recognised in the other member states. Inspection takes place by means of a so-called prospectus that contains key financial and non-financial data. This prospectus, which must be published, therefore represents a 'European banking passport' for securities in the EU Single Market.

kets. A solid financial market architecture is, despite the vociferous protests of financial lobbyists, not a competitive disadvantage, but on the contrary a competitive advantage for all European financial market actors.

References

CEBS 2008: Second part of CEBS's technical advice to the European Commission on the review of the large exposures rules: http://www.c-ebs.org/press/documents/2nd.LE_advice.pdf

EU Commission (2004): Turning the Corner: Preparing the challenge of the next phase of European capital market integration: http://ec.europa.eu/internal_market/finances/docs/actionplan/index/progress10_en.pdf

EU Commission (2006): Financial Integration Monitor 2006, Brussels: http://ec.europa.eu/internal_market/finances/docs/cross-sector/fin-integration/060728fim_en.pdf

EU Commission (2008a): Second public consultation paper on possible changes to the Capital Requirements Directive: http://ec.europa.eu/internal_market/bank/docs/regcapital/consultation2_en.pdf

EU Commission (2008b): Proposal for a regulatory framework for CRAs: http://ec.europa.eu/internal_market/consultations/docs/securities_agencies/consultation-cra-framework_en.pdf

IIF (2008): Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practices Recommendations: http://www.iif.com/download.php?id=Osk8Cwl08yw=

International Monetary Fund (2007): Global Financial Stability Report, Washington DC.
http://www.imf.org/External/Pubs/FT/GFSR/2007/02/pdf/text.pdf

Kellermann, Christian (2007): Kollabierendes Finanzsystem, Internationale Politikanalyse; Friedrich-Ebert-Stiftung, Berlin http://library.fes.de/pdf-files/id/04866.pdf

Weber, Axel (2007): Europäische Finanzmarktintegration aus Notenbanksicht, Deutsche Bundesbank, Frankfurt a.M.
http://www.bundesbank.de/download/presse/reden/2007/20071031.weber.pdf

Schrooten, Mechthild (2005): Finanzmarktintegration in Europa, MES-Schriftenreihe, Frankfurt a.d. Oder; http://www.mes.euv-frankfurt-o.de/data/schrooten.pdf

SPE-Fraktion (2006): Hedge Funds and Private Equity – A Critical Analysis, available at: http://www.socialistgroup.org/gpes/publist.do?lg=de

Imprint
Friedrich-Ebert-Stiftung
International Policy Analysis
Division for International Dialogue
D-10785 Berlin

www.fes.de/ipa
E-Mail: info.ipa@fes.de

ISBN 978-3-89892-970-7

Orders
Friedrich-Ebert-Stiftung
International Policy Analysis
z. Hd. Ursula Müller
D-53170 Bonn

E-Mail: info.ipa@fes.de
Fax: +49 (228) 883-625

All texts are available online:
www.fes.de/ipa

The views expressed in this publication are not necessarily those of the Friedrich-Ebert-Stiftung or of the organization for which the author works.