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Study Group Europe*

Civilise the Financial Markets!

12 Proposals for Regulating European Financial Markets

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1 The Problem

The crisis on the financial markets, which began in summer 2007 and escalated massively in 2008, is the most severe since the world economic crisis of 1929-33. It is wreaking havoc not only in the financial sector itself, but also in the real economy, with dire repercussions for the general population, not least working people. The consequences of aggressive risk-taking on the part of investors and financial institutions and their pursuit of inordinate returns will have to be shouldered by everyone. Losses are being socialised as immense resources from tax funds and central bank reserves are committed. This affects the broader populace.

The crisis underlines the enormous importance of the financial and capital markets for modern economies. At the same time, it shows that the financial and capital markets cannot be left at the mercy of the free play of market forces, but must be politically regulated. We can no longer rely on voluntary agreements and self-monitoring in this sector of the economy. Precisely because the financial and capital markets carry such immense risks they have to be oriented towards sustainability and regulated by the state. What is needed here is intelligent regulation that, while limiting losses as far as possible, at the same time harnesses the essential functions of the financial and capital markets and thereby contributes to a sustainable economy.

The financial crisis was able to assume such alarming proportions because it emerged from one of the core elements of our economy, the banking system. Among the fundamental causes of the crisis we might mention the following: the provision of excessive liquidity or excessive lending by the credit institutions; easy and negligent loan allocation as regards financial investors and consumers; misguided objectives, control principles and incentive systems in the financial sector, which lured people into excessively risky practices; the development of complex and opaque **financial products**[1] loaded with risk; large-volume and opaque insurance transactions on loans; and the inaccurate assessment of bonds by **rating agencies**.

The EU has a special role to play in dealing with these causes. Even though an international approach is desirable in almost every area, the EU can and must set an example and develop further existing European regulations – the **Banking Consolidation Directive** (2006/48) and the **Capital Adequacy Directive** (2006/49). The European Commission's proposals for a regulation on credit **rating agencies** and a capital requirements directive (CRD) point in the right direction. The EU must take account of the major economic blocs that have emerged in the wake of globalisation and weigh its economic strengths, creating its own structures to foster and control efficient financial and capital markets.

2 Requirements

1. The principles of sustainability have to be incorporated into the existing rules and regulations governing the real economy and the financial and capital markets. The financial and capital markets ought to serve the real economy. Alongside an orientation towards the long term, buffers have to be put in place at all levels of the economy capable of absorbing economic setbacks and crises. To deal with such exceptional circumstances enterprises, banks, local authorities, states, social security systems and central banks need adequate capital reserves. On top of that, limits have to be laid down for the fashioning of **financial products** and for the level of gearing in financial transactions.
2. We need a keener awareness of responsibility and risk in the financial system as a whole. The decision to issue a loan and the responsibility for the attendant risk must in future be linked. Financial institutions should therefore no longer be permitted to securitise and pass on their credit risks up to 100 per cent. In future, subject to international regulation they should have to bear at least 20 per cent of the risk themselves. The figure of 5 per cent suggested in the European Commission's proposal for a regulation is too low. Apart from that, minimum capital ratios should be introduced, independent of risk assessment. This would serve to limit **leverage**. Capital ratios in the allocation of credits to **hedge funds** must clearly be raised. In order that risks can be better appraised the EU must further develop accounting regulations: **special purpose vehicles** should be included in the balance sheet, **fair value assessment** must be scrutinised and there must be a return to the **lower of cost or market** principle.
3. European supervisory bodies should instigate procedures in international organisations that over the long term lead to an international registration

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1 Terms in bold are explained in the glossary.

office for financial innovations. The first step would be the medium-term establishment of a registration office at European level. This would be tasked with ensuring that **financial products** were standardised and simplified, and characterised by a high degree of transparency and the lowest possible individual and systemic risks. Similarly, the EU should work towards an international clearing house for **derivatives** that in the medium term eliminates bilateral contracts for these products. Here too the first steps could be taken at European level.

4. We need more effective European supervision. The national fragmentation of regulatory authorities in Europe enables financial market actors to avoid the jurisdiction of particular authorities and play them off against one another. As it stands, there is neither an effective European supervisory body nor has any effort been made to clamp down on the race to introduce the laxest possible supervision. As a next step, therefore, colleges of supervisors involved with international banks must be authorised to take binding decisions. A supervisor's voting rights should depend on the extent of business conducted in their respective country (volume and value added). How to reach necessary decisions even in the case of disagreement between the supervisory authorities of the member states needs to be regulated at European level. In addition, it must be ensured that the relevant decisions are binding on all the supervisory authorities involved. The European Commission's proposals of 1 October 2008, which give the consolidated supervisor the casting vote in the case of disagreement, are a step in the right direction. We need effective collective supervision. Should cooperation between national supervisory authorities prove unsatisfactory, the next step should be to set up a central European regulatory authority.
5. The supervisory authority should also scrutinise binding efficient risk models, which should be continually improved in consultation with experts. These models should include not only normal risks, but also major, systemic risks. They should be imposed on the banks and the financial and capital markets as mandatory since they form the indispensible basis for effective risk management, whose core is the anti-cyclical calculation of risk.
6. The EU must join with other economic blocs, in particular the USA, to achieve long-term standardisation of financial and capital market regulation. This can be ensured only by means of permanent dialogue on binding agreements. In the most important areas the first regulatory measures should be taken as soon as possible. Given that even a unified system within the EU has only limited scope, international cooperation is of particular importance here.
7. The EU should push for thoroughgoing reform of the most important international financial market institutions, in particular the International Monetary Fund, the **Bank for International Settlements** and the **Financial Stability Forum**. These institutions should be put in a position to carry out better and timely analyses of financial and capital market developments that are as independent and accurate as possible. They ought to propose suitable measures for worldwide regulation; and to ensure continuing and mandatory communication at a high level concerning market developments. The EU should be represented by a single voice in international financial institutions and also actively contribute to shifting the balance of voting rights in favour of developing countries.
8. The European Commission has to heed the national characteristics of the member states. In Germany the three-part banking system has proved its mettle; it must not be sacrificed to European competition law.
9. Tax havens and largely regulation- and law-free **offshore financial centres**, which have contributed to the unchecked growth of financial markets, may be found in Europe too and a crackdown is a matter of urgency. The EU must recognise its special responsibility here too and take joint action to that end. Although the current **EU Savings Directive** constitutes a first contribution to fairness in tax competition, in its existing form it falls far short of effectively preventing tax flight and tax evasion. It must be considerably extended.
10. There ought to be a European agency to register and control – by imposing clearer standards – **rating agencies**. On top of that, one or several European **rating agencies** should be established to instigate competition in sustainable and transparent rating procedures. The agencies should strictly separate rating and consultation, make their rating procedures publicly transparent and be obliged to implement sustainable risk models. **Rating agencies** should be subject to constant supervision, continuously checking the accuracy of assessments and procedures. Clearer rules, better and more transparent assessment methods and more supervision would endow classical rating with the additional function of providing a

»financial product MOT«, which would furnish early warnings in the event of major adverse changes in product risk. The European Commission's proposal for a regulation contains a number of important substantive rules, although the envisaged implementation by national authorities appears questionable. European regulations should be adapted to reduce the importance of ratings to a certain extent. A »good rating« of **financial products** should not relieve those responsible of making their own risk assessments. The **accounting rules** in accordance with the US GAAP (Generally Accepted Accounting Principles) or the IFRS (International Financial Reporting Standards), which henceforth will also be adopted in German commercial law to some extent (*Bilanzrechtsmodernisierungsgesetz* – Accounting Law Reform Act), are too much oriented towards the short term. This development must be reversed on a number of central points. Quarterly company reports, **fair value assessments** and **mark-to-market** rules may in good times give short-term oriented investors timely indications concerning the intrinsic value and profitability of investments. In crises, however, even this short-term benefit breaks down. In addition, these principles are open to fundamental criticism. They have led on – sometimes even compelled – actors in both the financial and the real economy to engage in ever riskier behaviour. At the same time, they reinforce procyclical developments in the economy by overvaluing assets in boom periods, thereby overheating the economy even further. In crises, these principles induce the undervaluation of assets and accelerate the downward spiral. The fair value principle, **mark-to-market** rules and the reporting of uncertain future returns in the balance sheet must therefore be revoked and replaced by principles of sustainable management: on the one hand, accounting in accordance with at the lower of cost or market and/or value at the time of purchase, and abandonment of the activation of future returns in the case of uncertain evaluations; and on the other hand, the inclusion of major risks. Accounting regulations must guarantee the disclosure of all banks' securitisation positions and their risks.

11. The capital requirements directives, too, under which **Basel II** has a special status for financial institutions, have so far been too much oriented towards short-term principles. Furthermore, they have not dealt properly with risks due to complex and barely comprehensible risk assessment models and the reliance on – opaque and inaccurate – ratings in the classification of risks. The following principles should be firmly embedded in European directives for the banking sector:
    - risk-independent indebtedness limits for financial institutions, for example, 4 per cent of the balance sheet total (limitation of bank **leverage**);
    - reporting of all risks in bank balance sheets, including transactions of **special purpose vehicles** and their committed credit lines; these risks should be covered with own capital;
    - minimum capital ratios for all credit risks;
    - higher capital ratios (by a factor of five) for very risky transactions, for example, for credits to and investments in **hedge funds**;
    - higher capital ratios for new financial products, for example, 40 per cent;
    - sound practice in relation to mortgage loans: at least a 20 per cent equity position on the part of the debtor, a check on income and assets, no variable rates and minimum redemption amounts. Redemption and interest should at most amount to a third of the debtor's income;
    - stricter provisions against period transformation (refinancing of long-term investments by means of short-dated securities): for example, use of commercial paper only for capital adequacy and risk minimisation;
    - orientation of bonus schemes for managers and other employees to the long term (at least three years); restriction of bonuses to 30 per cent of fixed salary; »maluses« (or »penalties«) in the event of poor economic performance (cancellation of bonus, reduction of fixed salary); restrictions on share options as a component of managers' salary; limitation of tax deductibility of emoluments and payments of board members as operating expenses to the order of 1 million euros and 50 per cent of any amount exceeding that.
12. **Hedge funds** and **private equity funds** should be regulated more strictly:
    - Regulations on transparency should include data on business models, ongoing transactions (fully up to date and differentiated in terms of problematic operations such as **short selling**), ownership structures and investors in the fund.
    - **Hedge fund** management companies must register in order to operate in the EU.
    - Special employee protection and codetermination rights, as well as rights to information and consultation in case of a change of control

on the investors'/shareholders' side should be embedded in company and labour law. There should also be options for corresponding company and codetermination agreements, as well as collective agreements.

- Regulatory barriers to the withdrawal of assets and the loading of debts on target companies should be introduced (for example, a minimum own capital for funds of 50 per cent or regulations on **minimum capital ratios** of target companies by modifying the Capital Directive (77/91/EC).
- A duty to pay business tax should be introduced for **private equity funds**.
- Fund managers' **carried interest** (the high proportion of total profits they receive) should be taxed as normal income and not as capital gains at a lower tax rate.

3 Prospects

After prioritising the liberalisation of financial markets with the **Financial Services Action Plan (FSAP)** the EU must now endeavour to guarantee the functionality of financial markets as a public good. The financial sector has no intrinsic value. The crucial levers for effective regulation of the financial markets have to be applied as follows: comprehensive supervision of all financial institutions and instruments; strict and simple capital adequacy for all financial institutions; limitation without exceptions of avoidance strategies beyond official supervision and balance sheets; and reduction of the complexity of financial market instruments. The principal aim of regulation is the fundamental reduction of the procyclical character of financial systems, which is linked to the current **»Basel II«** logic and executive remuneration. The EU member states must put aside national egoism and take the required measures together – only a strong and united community will be able to generate the necessary momentum at international level.

Glossary

Accounting rules lay down, among other things, the rules in accordance with which an undertaking has to value its assets and put them in the balance sheet. A distinction is made between *fair value assessment* (or *mark-to-market* assessment) and the at the *lower of cost or market* principle. In accordance with the principles of international accounting (US-GAAP and IFRS) the principles of *mark-to-market* or *fair value assessment* have to apply. Accordingly, assets have to be entered in the balance sheet at the current market value. Fluctuations in market prices therefore lead to corresponding changes in the balance sheet. These assessment principles therefore have a procyclical effect and intensify booms and crises.

The **Accounting Law Modernisation Act** (*Bilanzrechtsmodernisierungsgesetz*) is a legislative project of the German Federal Government for the reform of German (Commercial Code) accounting legislation. It brings the previous regulations more closely into line with the principles of international accounting systems. For example, it lays down accounting guidelines for *special purpose vehicles*. *Fair value assessment* is altered to make it less procyclical. The law should be passed within the current 16th legislative period.

The **Bank for International Settlements (BIS)** is a public limited company with its head office in Basel. BIS shareholders are almost all European central banks. The Bank's activities include fostering cooperation between central banks.

The **Banking Consolidation Directive** (2006/48) regulates the taking up and pursuit of the business of credit institutions of the EU member states and their supervision.

»Basel II« is a set of rules issued by the Basel Committee on Banking Supervision introduced in the EU end of 2006/beginning of 2007. It regulates capital requirements for banks. The greater the default risk to which the bank is exposed, the greater the amount of capital the bank needs to put in its balance sheet. This has »procyclical« effects because in a cyclical downturn financial risk increases. Due to capital requirements this leads to a reduction of bank lending and so further aggravates the economic downturn. The reverse situation holds in an upturn.

The **Capital Adequacy Directive** (2006/49) lays down capital requirements for investment firms and credit institutions, as well as regulations for their calculation and supervision. This is supposed to guarantee the liquidity of financial institutions even in the case of bad credit events.

Carried interest is a kind of profit-sharing for investment companies and their employees, borne by investors in a private equity fund. Usually, fund managers receive a share (generally 20 per cent) of the profits from capital investments.

A **clearing house for financial products** is a central office for the settlement and clearing of credit *derivatives* and financial products. Credit *derivatives* have so far largely been traded over the counter and are therefore difficult to control. The most important types of credit *derivatives* are credit default swaps (CDS), a form of insurance against loan defaults. The nominal value of outstanding CDSs was valued at over 60 trillion dollars as early as the end of 2007.

Commercial papers are unsecured short-term debt instruments, which usually serve to meet short-term debt obligations of the issuer (issuing company). Investors include especially investment companies, insurance companies and large companies.

Derivatives are financial market instruments whose values are derived from the value of something else, for example, shares, corporate bonds or exchange rates. The value of *derivatives* fluctuates with the movement of the underlying base value (»the underlying«). A set of *derivatives* operates on the basis of *leverage*: in this way the value of the derivative fluctuates much more than the underlying. This increases the likelihood of losses or risk. *Derivatives* therefore act like bets on the underlying.

European Commission draft regulation on rating agencies. With this initiative the European Commission in particular wishes to lay down an obligation for *rating agencies* to register, as well as rules to prevent conflicts of interest on the part of agencies.

The **EU Savings Directive** provides that from 2005 EU member states will supply information on the savings income of foreign investors to their home tax offices. In the country of residence income should be taxed in accordance with the locally applicable fiscal laws. For some countries, such as Switzerland and Liechtenstein, there are exceptions, however. To protect bank secrecy these states can transfer a flat rate withholding tax.

Fair-value-assessment see *Accounting rules*

Financial market supervision denotes state supervision of financial market actors. Depending on the country there is either a central authority (»single supervision system«) or a number of authorities for different sectors of the financial market (banking supervision, stock market supervision, insurance supervision).

Financial products are investment and financial instruments offered by, for example, banks, independent financial advisers, securities companies, investment companies, and so on.

The **Financial Services Action Plan (FSAP)** is an action plan drawn up by the European Commission with a view to creating a unified European financial market.

The **Financial Stability Forum** set up by the G7 in 1999 comprises finance ministers, central bankers and international financial institutions. The aim of the Forum, established at the *Bank for International Settlements*, is to promote international financial stability. Its aim is to facilitate the supervision of financial institutions and transactions.

Hedge funds are a special kind of investment fund that pursue highly risky investment strategies (for example, *short selling*). Alongside their own capital *hedge funds* as a rule invest external capital in order to generate *leverage*. The increased yield opportunities go hand in hand with high risk.

Leverage in a financial transaction refers to the relationship between internal and outside capital. If an investor can borrow outside capital at a lower rate or under more favourable conditions than he can obtain as a return on capital employed it is called a *leverage effect*, since the use of additional outside capital frees more own capital which can be used for further investments. This is conditional upon the interest rate for the outside capital being lower than the interest on the total capital invested. The drawback is that the risk increases with higher indebtedness, for example, in the form of a greater probability of insolvency.

The **lower of cost or market principle** of earlier German accounting principles is a rule of adequate and orderly bookkeeping. It serves to protect the creditor and must be observed in the preparation of the company balance sheet. In accordance with the *lower of cost or market principle* an evaluation of individual balance sheet items must be carried out according to the principle of prudence (or conservatism principle). While assets should be estimated at the lowest price, debts should be reported at the highest.

The **(minimum) required capital ratio** is the relationship between the (minimum) required capital and an enterprise's total capital, or in the case of a bank the total amount of originated loans. The lower the ratio, the more exposed the institution is and the greater the risk to creditors of loan defaults.

Mark-to-market see *Accounting rules*

Offshore financial centres are international financial centres where banks conduct business principally or exclusively with non-residents. *Offshore financial centres* are characterised by the pronounced absence of central bank policy measures, a high level of deregulation and very low taxation of profits.

Private equity funds pool investors' resources and use them to purchase shareholdings in companies (majority if possible) in order to realise the highest possible profit after an investment period of around two to eight years (»exit«). The profits are distributed to the investors after the withdrawal of a very high share for the fund manager (*carried interest*) and an administrative fee.

Rating agencies are private (and profit-oriented) service companies that assess the creditworthiness (soundness) of enterprises and states, as well as the risk of *financial products*. Assessment (so-called »ratings«) as a rule takes the form of letters: AAA (»triple A«) is the highest rating (almost no chance of default). The worst rating is D (in payment default).

Short selling involves the seller of an asset speculating on a fall in prices. For this purpose he borrows securities for a lending fee or premium (for example, from investment banks) and sells them in the market. If the price falls as expected he can buy the securities at a more favourable price in the market and return them to the lender. The spread between the selling and the repurchase price constitutes the speculative profit. In so-called »naked short selling« a security is sold short without the seller even bothering to borrow it.

A **special purpose vehicle** is a legal entity established to fulfil a specific objective. A number of banks have set up *special purpose vehicles* (conduits or structured investment vehicles) to refinance long-term investments with short-dated commercial paper or to hold high risk structured *financial products*. Under the previous »Basel I« capital requirements these companies and the credit lines committed to them did not have to be reported in the balance sheet. In accordance with the new provisions of »*Basel II*«, which were introduced in the EU member states in 2007 and 2008, but not in the USA, this is no longer permitted. Companies established under these requirements have caused enormous losses in numerous banks in several countries because in the financial crisis the corresponding loans and securities connected to the special purpose vehicles were devalued.

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