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EU Financial Market Reform

Status and Prospects, Spring 2010

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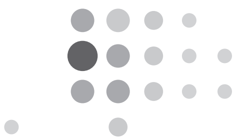
- The financial and economic crisis has made it clear that the financial markets are in need of far-reaching reform and more effective regulation. Since the most pressing dangers have been averted and the economy in most industrialised countries is clear of recession, however, the topic of financial market regulation has largely disappeared from the public gaze.

- Having said that, a great deal is happening in the background with regard to financial market regulation, including at the EU level. Against this background, economists Sebastian Dullien and Hansjörg Herr present the current state of the debate in some of the most important areas of EU financial market regulation and ongoing legislative processes and evaluate the most important plans.

- The authors come to the conclusion that, although the current deliberations on reform are going in the right direction, they are insufficient to ensure the long-term stability of the EU financial system. For example, the European Commission's initiatives and even more so the ideas of the Council amount to an unacceptable dilution of the demands of the De Larosière expert group. Dullien and Herr demonstrate these defects and develop alternative proposals by means of which the European Parliament could implement substantial EU financial market reforms.



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1 Introduction

Since the outbreak of the current financial and economic crisis in 2007 and its intensification after the collapse of US investment bank Lehman Brothers in September 2008 there has been no shortage of grandiloquent words as politicians have sought to describe what is to be done differently in the financial sector in future. »Making banking boring« was suddenly the phrase on everyone's lips. As late as September 2009, at the G20 summit in Pittsburgh, the Leaders' Statement declared: »Today we agreed: … To make sure our regulatory system for banks and other financial firms reins in the excesses that led to the crisis. Where reckless behavior and a lack of responsibility led to crisis, we will not allow a return to banking as usual«. However, since for the time being critical threats have been averted and the economies of most industrialised countries have come out of recession, financial market regulation has faded from public view. This applies in particular to Europe where, traditionally, legislation at the European level – where decisions on financial market regulation are made, as a result of the Single Market – has figured far less prominently in the predominantly national media than the reporting of national legislation.

In fact, however, a great deal is happening in the background with regard to financial market regulation. The European Commission has already presented a number of draft directives which are now slowly making their way through the European decision-making bodies.

The aim of this paper is to present and evaluate the current status of the debates and legislative procedures with regard to some of the most important areas of financial market regulation. We shall limit ourselves to financial market supervision and financial market regulation in the narrow sense. Although the authors are convinced that macroeconomic imbalances played a significant role in the origins and outbreak of the global financial and economic crisis of 2008–2009, for reasons of space they must largely be left to one side.[1]

In what follows, we shall scrutinise three areas of financial market regulation which have particular significance for the EU. First, financial market supervision at the EU level – that is, banking, securities and insurance; second, the banks' capital requirements; and third, the regulation of derivatives markets in the EU, including the rating agencies.[2]

2 Requirements of Well-Functioning Financial Market Regulation at the EU Level

Before attempting to assess current developments in financial market regulation it is worth taking one more look at where problems emerged in the latest crisis and what is required for a better system of financial market supervision.

2.1 Comprehensive, Uniform Oversight of All Products and Institutions

A fundamental problem not only with the latest, but also previous financial and banking crises was often not so much that the banks were not regulated at home, but that other financial institutions or other jurisdictions were less strictly regulated than the native banks and that the commercial banks took advantage of this by transferring particularly risky transactions to less regulated parts of the financial system (regulatory arbitrage). Before the latest crisis, for example, many banks externalised their transactions involving US subprime securities in the form of so-called special purpose vehicles, often located in less regulated financial centres, making it possible, among other things, to circumvent capital requirements. The risk remained for the commercial banks through their credit and ownership links with the so-called »shadow banks« (Brunnermeier et al. 2009). In the event, this behaviour, together with the regulatory differences in different parts of the financial sector, led not only to a more risky, but also to a more opaque financial system.

The development of the US subprime crisis cannot be understood without taking a look at the still extremely fragmented state of financial supervision in the USA. For example, most subprime mortgages were issued not by banks, but by mortgage companies which were subject only to state-level regulation (Gramlich 2007). Many

1. Those interested might consult Dullien et al. (2009).

2. The matters that will not be dealt with explicitly include the control of hedge funds and other high-risk funds, a European deposit guarantee, a European bankruptcy law and unregulated – or only lightly – offshore centres in Europe itself, the purpose of which is to take advantage of regulatory arbitrage and tax evasion.

states exercised their regulatory powers so loosely that in fact there was no regulation at all. The securities of investment banks were securitised and in any case such banks were not subject to the same strict rules as normal commercial banks.

Most authors are therefore in agreement that a central requirement of a well-functioning and powerful financial supervision is that it is as complete and comprehensive as possible. It is crucial that all financial institutions – regardless of their legal nature – and all financial products are included. Regulation should be directed towards what a product's function is and what kind of transactions an institution is involved in, not the legal character of the product or institution. Only in this way can regulatory arbitrage be effectively prevented (Dullien et al. 2009: 154ff).

At the European level, there are further arguments for the harmonisation and – at least partial – centralisation of regulation and oversight in the financial system. On the one hand, the shifting of transactions to countries with lower regulatory standards is particularly easy due to the Single Market. On the other hand, there is a significant danger that the consequences of inadequate financial market regulation will spill over to the other countries. First of all, the financial institutions in Europe are very closely intertwined and second, the current crisis and the debate on financial assistance for the heavily indebted Greece have shown that there is an implicit obligation of liability among the partners for the debts of an individual country.[3] This implies an enormous moral hazard problem in the absence of a uniform financial supervision: individual countries always have the incentive to regulate financial institutions more loosely than other countries do in order to attract them. Potential costs in the event of a crisis are at least partially externalised. Even basically uniform rules at the EU level are of no help against this problem unless there is a uniform supervision, because national authorities have an incentive to interpret the rules as loosely as possible.

The most sensible option would be a supervisory system whose structure resembled the European system of central banks, with a centralised authority which takes important decisions and subordinate national authorities which implement these decisions. This would mean supervisory authorities with large staffs on the ground in the respective countries which, among other things, would undertake the on-site supervision of financial institutions – just as, at present, the national central banks in their day-to-day dealings with the commercial banks implement the European Central Bank's (ECB) monetary policy.

3. The explicit no-bail-out clause has thus in the meantime become an implicit bail-out guarantee (cf. Dullien/Schwarzer 2009).

2.2 Capital Adequacy Requirements and Rating Agencies

Another problem responsible for the current crisis was the banks' gluttonous appetite for risk. In all major industrialised countries, in recent years, the banks' capital buffer has been systematically reduced, causing the debt-equity ratio – so-called gearing or leverage – to rise rapidly. For example, equity at institutions such as Deutsche Bank or the Swiss bank UBS was reduced from almost ten per cent at the beginning of the 1990s to two to three per cent before the outbreak of the latest financial market crisis (Hellwig 2008: 44).

One reason for this development may well have been the reform of the rules on capital adequacy (the so-called Basel II standards). The earlier, relatively simple equity capital guidelines were replaced by new, more complex guidelines, under which each investment by a bank had to be backed by equity capital in accordance with its specific risk. The risk of an investment in each instance was determined by an internal or external rating.

There were three problems with this. First, using internal risk models, the dangers arising from certain investments were likely to be assessed as low as a matter of course. Although individual risk models had to be approved by the banking supervision, there was an incentive to adopt models which evaluated the risks as low and entailed low capital adequacy. Second, a strong pro-cyclical element was introduced into the banks' lending. Ratings tend to improve systematically in an upswing and to be downgraded in a downturn. In connection with Basel II, the problem arose that, in good times, the banks did not have to hold so much capital and thus could expand their credit portfolio. This is likely to have further fuelled the boom, for example, in mortgage allocation. In the downturn, in contrast, more equity capital was abruptly required, so that the banks, in the very period in which the

economy needed more expansive lending, were forced to curtail it. Third, the close links between financial institutions and rating agencies became problematic: because, in particular, the evaluation of structured financial products was very profitable for the rating agencies and, at the same time, such evaluations were commissioned and paid for by the issuing financial institutions, there was an incentive to provide even dubious products with good ratings. Furthermore, for smaller financial institutions, which do not use their own risk models, rating agencies took over risk evaluation.

Commercial banks traditionally pursued a business model which concentrated, first and foremost, on lending to non-financial institutions, that is, to companies, private households and public authorities. In addition, banks traded on capital markets, currency markets and other speculative markets on behalf of others. In particular, banks operating internationally in recent years have dramatically increased the volume of proprietary trading. This means that they carried out speculative bond, foreign currency, precious metals and, not least, derivatives transactions on their own account.

These risky transactions on the part of the commercial banks should be strictly limited in order to prevent them from using their privileged access to central banks (to refinance their lending) to engage in highly speculative activities. One option would be to impose particularly high capital requirements – up to 100 per cent – on proprietary trading. Alternatively, a far-reaching ban on speculative transactions in the proprietary trading of commercial banks should be contemplated. US President Barack Obama, based on the recommendations of former Chairman of the Federal Reserve Paul Volcker, has proposed reforms along these lines.[4] Both options would also lead to a limitation or even reduction of the size of financial institutions, which in any case is desirable on regulatory grounds. To be sure, in both instances it must be ensured that commercial bank loans to other highly speculative actors in the financial sector – hedge funds, private equity funds and so on – are limited. Likewise, in this case particularly high capital requirements and an outright ban are equally worthy of consideration.

The commercial banks not only engaged in risky transactions in proprietary trading, but also financed other financial institutions, such as investment banks, hedge funds and private equity funds, whose business models are, as a rule, highly risk oriented and speculative. As a result, a direct channel emerged between the creation of money by central banks, the commercial banks' credit expansion and the credit financed speculation of risk-taking financial market actors. The central banks had no instrument at their disposal to promote credit expansion in productive branches or to impede the financing of speculative activities, which led to asset market bubbles. For risk capital – for example, in the form of venture capital – more than enough funds are still available, because non-commercial banks can attract investments, for example, from risk-seeking private households.

The revision of equity capital rules is therefore key to effective reform of financial market regulations. The following points are of particular importance in this regard:

1. Capital requirements should, by and large, be higher than they are now.

2. Banks should be compelled to back transactions externalised in special purpose vehicles or similar institutions with equity capital.

3. The hitherto pro-cyclical effects of equity capital rules should be eliminated, for example, by introducing obligations on banks, in good times, to build up capital reserves or by means of capital requirements which vary countercyclically over the economic cycle.

4. The rating agencies' role in the process should be reduced; furthermore, rating agencies' payment model should be changed so that they no longer have an incentive to evaluate securities in the interests of their issuers. The establishment of a European rating agency could break the monopoly of the private rating agencies, which have failed.

5. Commercial banks' proprietary trading must be subject to very high capital requirements. The same applies to commercial banks' lending to non-banks in the financial sector. Alternatively, proprietary trading could be banned and strict limits considered on commercial banks' loans to non-bank financial institutions.

4. Cf. *Financial Times Deutschland,* 21 January 2010.

2.3 New Rules for Derivatives Trading and Securitisation

Another problem which has attracted renewed attention in the current crisis is the growing significance of unregulated bilateral trading – over the counter or OTC – of financial derivatives. A particular focus is the market for credit default swaps (CDS) which, according to current estimates, is now worth more than 60 trillion US dollars. Many have predicted that problems on the CDS market could usher in a new round of bank failures.[5] This fundamental problem of the CDS market also applies to many other derivatives and financial innovations.

One of the main difficulties of the derivatives market is that, because of its bilateral nature, it is unclear which market participants hold what positions and whether there is a concentration of risk or not. In the event of more dramatic price movements or the insolvency of a firm the purchaser of a derivative – for example, a CDS – can find itself in financial difficulties. Furthermore, if an OTC counterparty goes bankrupt, the other also comes under threat. In the past, market participants just blindly assumed that OTC counterparties could always step into the breach. In this way, business strategies were classed, from a microeconomic perspective, as safeguarded, although from a macroeconomic perspective it ought to have been clear that this was not the case. As a result, financial institutions signalled solvency and liquidity positions from the microeconomic level which rapidly proved to be illusory in the crisis.

Precisely these dangers manifested themselves in the course of the nationalisation of US insurance group AIG and the bankruptcy of Lehman Brothers. AIG had enormous sums outstanding in CDSs, so that the US government feared a domino effect of bank failures if the company went bankrupt. There was a similar fear in the case of the investment bank Lehman Brothers, which ultimately led to the state more or less doing whatever it took to rescue the situation after its collapse. The fact was, however, that the supervisory authorities simply could not foresee the consequences of insolvencies.

One solution to the problem of risky OTC derivatives markets would be to transfer all such transactions to central clearing houses on a compulsory basis. A central clearing house would have a number of advantages. First, regulators would be provided with summary information on current risks, as all transactions would go through it. Regulators could see at a glance who had taken what positions and counterpositions, so that the net risk of a bank failure could be more easily assessed. Second, a central clearing house would provide some sort of protection in the selection of counterparties in derivatives trading: depending on the development of liabilities from derivatives contracts counterparties would have to deposit a certain proportion of these liabilities at the clearing house in the form of bank deposits or highly liquid government bonds. Although it would not be absolutely guaranteed that the counterparties could eventually fulfil their commitments, the accumulation of extremely risky positions almost without the use of own funds would be prevented. Third, the obligation to deposit liquid securities automatically limits the amount of derivatives that individual financial institutions can issue. In this way, in turn, the risk and volume of the derivatives market, if desired, can be reduced relatively simply by increasing the deposit obligation and ensuring that derivatives trades involve a higher proportion of investors' own funds. A higher deposit obligation functions like a fee which makes hedging transactions moderately more expensive and counteracts an excessively high inclination towards risk on the markets.

With the securitisation of credit instruments the original lender sells his claims arising from lending to a third party. A large number of loans can, as frequently happened before the subprime crisis, be pooled and divided into tranches, allowing the process to be repeated a number of times. The distance between the original lender and the final holder of the loan, who bears the default risk, thereby becomes greater. The risk of moral hazard also emerges because the original lender, in granting credit, no longer applies strict standards, since he can sell the risks and de facto operates as a credit broker. Rating agencies, as the subprime crisis has shown, were not in a position to evaluate sometimes very complex securitisations adequately. In order to solve this problem we propose that the original lender should be obliged to hold an appropriate portion of the granted credit until the term of the loan is reached.[6] It must be taken into account that the original lender holds a large portion of the

5. See, for example, Münchau (2009).

6. The SPD party executive's project group »More Transparency and Stability on the Financial Markets« in October 2008 called for the retention of 20 per cent. This seems appropriate to us.

»first loss« part, that is, the tranche which suffers first in the event of default.

The question arises, in the face of the seemingly relentless emergence of financial innovations – which overall make financial markets increasingly opaque, even for experts and supervisory authorities – of how to deal with new financial products. A large number of these products are not financial innovations at all, but rather the result of regulatory arbitrage. In Dullien et al. (2009), the introduction of a financial »MOT« (in German: TÜV or Technischer Überwachungs-Verein [Technical Inspection Association]) is proposed as a solution. In contrast to what is usually put forward when this matter is raised in the public debate, it would not, in the first instance, be the task of a financial MOT to bar access to certain risky forms of investment to small investors. The point would rather be to subject all products – that is, also those in use only in inter-bank trading – to strict examination before they are introduced on the market.

The approach taken to the licensing of drugs should serve as the model here: a financial institution which wants to introduce a new product or a new type of contract must first prove that the individual or national economic use of the new product is proportionate to the risk and to any increase in market opacity on account of the product. Products which represent no discernible improvement over existing contracts should be rejected in this process, as should innovations with excessive risk. Good innovations, in contrast, may continue to be developed and find their way into the market.

3 Current Reform Progress at the EU Level

Many of the elements proposed above are reflected in the proposals being discussed at the EU level. Of central importance for the EU debate is the report by the so-called De Larosière Group, which was ordered by the European Commission and presented in February 2009, which more or less serves as the basis for the proposals for a Directive which the Commission got under way in the course of 2009.

3.1 Financial Supervision Package

A key element of the Commission proposals is the creation of a European System for Financial Supervision (ESFS). Basically, the idea of a unified supervisory structure goes back to the outline presented by the De Larosière Group (De Larosière Report 2009: p. 48ff), the proposed structure of which was adopted virtually unaltered in the draft directive presented by the European Commission in September 2009 (European Commission 2009).

This system is intended to form a network of European financial supervisory authorities (see Figure 1). The three previously existing so-called »Level 3 committees« for the regulation of banks, insurance companies and securities supervision – the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions (CEIOPS) and the Committee of European Securities Regulators (CESR) – are to be upgraded to authorities with offices in Frankfurt, Paris and London. At the same time, national supervisory authorities would continue to be concerned mainly with the supervision of financial institutions and markets, while the newly established European Supervisory Authorities (ESA) are to adopt a coordination function and, among other things, »coordinate the application of common high level supervisory standards«, as well as directly monitoring individual cross-border institutions.

A European Systemic Risk Board (ESRB) is to be set up alongside these Supervisory Authorities, to assess macroeconomic risks and make recommendations when things take a wrong turn. The plan is that the ESRB's Taxation Committee should have 33 voting members, namely the 27 national central bank heads, the ECB President and vice-president, a representative of the European Commission and the heads of the three ESAs. The main task of this committee would be to issue warnings and recommendations. The ESRB's secretariat is to be located at the ECB in Frankfurt.

Apart from the basic structure, the powers envisaged for the Authorities in the legislative process represent a marked dilution in comparison to the De Larosière proposal. In the De Larosière Report, ESA experts were granted relatively substantial »break-through rights« in the form of mandatory instructions to national supervisory authorities. For example, it had been recommended

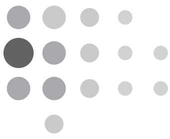

Figure 1 A new European framework for safeguarding financial market stability

Macro-prudential supervision

»European Systemic Risk Council« (ESRC)
[Chaired by President ECB]

Members of ECB/ESCB General Council (with alternates where necessary) + Chairs of EBA, EIA&ESA + European Commission

Main tasks of the European Systemic Risk Council: decide on macro-prudential policy, provide early risk warning to EU supervisors, compare observations on macro-economic and prudential developments and give direction on these issues.

Information on micro-prudential developments

Early risk warning

Micro-prudential supervision

»European System of Financial Supervision« (ESFS)

»European Banking Authority« (EBA) ↔ »European Insurance Authority« (EIA) ↔ »European Securities Authority« (ESA)

National Banking Supervisors ↔ National Insurance Supervisors ↔ National Securities Supervisors

Main tasks of the Authorities: in addition to the competences of the existing level 3 committees, the Authorities would have the following key-competences: (i) legally binding mediation between national supervisors, (ii) adoption of binding supervisory standards, (iii) adoption of binding technical decisions applicable to individual institutions, (iv) oversight and coordination of colleges of supervisors, (v) licensing and supervision of specific EU-wide institutions (e.g., Credit Rating Agencies and posttrading infrastructures), (vi) binding cooperation with the ESRC to ensure adequate macro-prudential supervision, and (vii) strong coordinating role in crisis situations.

Main tasks of national supervisors: continue to be fully responsible for day-to-day supervision of firms.

Source: De Larosière Report (2009), p. 65.

that the new authorities could challenge »the performance by any national supervisor of its supervisory responsibilities … and to issue rulings aimed at ensuring that national supervisors correct the weaknesses that have been identified. In the event of the national supervisor failing to respond to this ruling, a series of graduated sanctions could be applied …« (De Larosière Report 2009: 60f).

In the draft presented by the European Commission (2009a; 2009b; 2009c) in September this idea no longer had the clarity of the first draft. It is true that the European Commission was given the right, when weaknesses in the implementation of EU financial market regulations by national financial supervisions came to the notice of the new EU authorities, to force them to change their policies. Furthermore, the direct practical powers of the new European authorities in relation to financial institutions such as rating agencies, central counterparties, including clearing houses, and similar European institutions were limited. This means that break-through rights with regard to »normal« financial institutions which operate predominantly at the cross-border level were dropped.

In comparison to the Commission's draft, the draft discussed in the Council of Ministers in December 2009 (Council of the European Union 2009) represented even thinner gruel. For example, the direct »breakthrough rights« of the planned European authorities with regard to financial institutions were further restricted and explicitly limited to rating agencies. What is more important, however, is that in this draft the European Commission's

authority to issue instructions to national supervisory authorities is deleted and downgraded to a mere recommendation. Furthermore, the European authorities' decision-making competence in an emergency is withdrawn. Finally, the draft envisages the possibility of member states exercising a veto against decisions of the European financial market supervision if they threaten their budgetary sovereignty. A critical feature of this provision is that, according to the Council draft, no justification is required with regard to why an individual member state considers its budgetary sovereignty to have been jeopardised and that such a veto automatically has a suspensive effect on the European authority's decision.

The package is currently being debated in the European Parliament and its first reading is due in May or June 2010. The question is, whether the Parliament will go along with the Council's desired changes or risk a conciliation procedure. The problem with such a conciliation procedure may be that the supervision directives are unlikely to be adopted in 2010.

The current state of reform with regard to financial market supervision represents an improvement in relation to the status quo, but it has grave defects which may hinder the emergence of a truly powerful and efficient EU financial market supervision through the planned directive.[7]

It is generally to be welcomed that further competences are being transferred to the financial supervision at the European level. This is a step which can prevent geographical regulatory arbitrage. Also generally positive is the fact that a special committee will be devoted at the European level to the topic of systemic risk and macroeconomic risks.

It is difficult to understand the planned structure of the supervisory authority, however. The division into three authorities, separated both geographically and in terms of subject-matter, is problematic. It is becoming increasingly difficult to assign modern financial institutions to a certain segment of the financial sector. The division of supervisory competence to three authorities brings with it the danger of divergent application of regulations and of transitions which lead to regulatory gaps. The recent crisis furnishes a vivid illustration of this: the US insurance group AIG was not forced onto the ropes on account of its insurance business, but because it gambled in the credit derivatives market, more precisely with credit default swaps (CDS). The US government took the view that it had no choice but to stage a rescue because AIG had engaged in such transactions with a multitude of banks and its bankruptcy would also have dragged these institutions under. The danger is that a fragmented supervision, like the one planned by the EU, would fail to see such connections.

The same applies to the geographical division of supervisory competence and the location of the authorities in three different cities and countries. Recognising the risks emerging at the interfaces between individual financial institutions requires the active exchange of views by supervisory personnel at all levels. The danger of geographical separation is that, although there will be regular meetings at the top level, those working at the coalface will be too isolated from one another to identify every threat in time.

Turning to the ESRB, its close linkage to the European Central Bank is a matter of concern. Although central banks have privileged access to information on financial stability, and the ECB has regularly published its *Financial Stability Review* since 2004, central banks tend to think and act by strict consensus. Most European central bankers are trained on the basis of similar models and modes of thinking, while many years of cooperation lead to further convergence of worldviews. As the US subprime crisis illustrated, it is often outsiders who identify risks. For example, the US Federal Reserve long ignored the risks attendant on the house price bubble, while economists such as Raghuram Rajan and Robert Shiller sounded the alarm. Experience of earlier financial crises shows that they generally do not arise where financial crises arose before, and that the dominant economic interpretation often underestimates developing threats. It would therefore be important to integrate maverick opinions in the evaluation of macroeconomic and systemic risks. This is ruled out by the overwhelming majority of 29 out of 33 votes for central bankers in the ESRB.

A further problem is the question of how central bankers in the committee react when ECB policy becomes a systemic risk. The question is whether, for example, the central bankers in the ESRB would agree to issue a warning about an over-hasty series of interest rate hikes by the

7. This section is based on Sebastian Dullien's testimony before the European Parliament's ECON Committee in January 2010 (Dullien 2010).

ECB, if they jeopardised macroeconomic stability in Europe.

Finally, it has to be said that, so far, the ECB has not exactly covered itself with glory in its crisis assessments. For example, in July 2008 – that is, almost one year after the first appearance of turbulence on the money markets (and when Europe's economy, as we now know, was already in recession) – the ECB raised interest rates once more. This, albeit small, interest rate increase is likely to have further aggravated the situation in the European banking sector. The ECB's decision can be explained only by the fact that it failed to perceive the seriousness of the situation at that time. There is no reason to believe that the ECB will do better in the future than it has so far.

To sum up, a better solution to the problems of financial sector supervision would be to create a single supervisory authority for the whole financial sector in one city (and best of all, in one building), which is responsible for the banks, insurance companies and the securities markets alike.

3.2 Changes in Capital Adequacy Requirements

The De Larosière Report regards the reduction of the equity capital of financial institutions as one of the reasons for the subprime crisis, and proposes a »fundamental review« of the Basel II framework (De Larosière Report 2009: 22). In detail, it is proposed to gradually increase the minimum capital requirements, to reduce the procyclical effect of Basel II, to introduce stricter rules for off-balance sheet positions, to tighten up liquidity management and to reinforce the provisions on internal control and risk management of banks. The Basel Committee of Banking Supervisors is called on to make the appropriate changes speedily. The Report also proposes the establishment of a common definition of regulatory capital, which should be confirmed by the Basel Committee. With reference to the mechanical application of banks' internal risk models there is also an explicit demand for management personnel and board members to make greater use of their own judgement and to possess high personal integrity and technical knowledge (De Larosière Report 2009: 22).

Concerning the shadow banking system, the Report calls for all firms of potential significance for the financial system to be subject to appropriate regulation. Particularly in the case of systemically important hedge funds a worldwide obligation to register and to provide information on strategies, methods and leverage, also in global transactions, is called for. For banks which conduct proprietary trading, an appropriate capital requirement should be set. This also applies to banks which are owners or operators of hedge funds (De Larosière Report 2009: 28f).

Although the proposals of the De Larosière Report do not include quantitative stipulations, their overall thrust is relatively far-reaching. The sole relevant difference with regard to our approach concerns whether proprietary trading should be permitted for commercial banks and how commercial bank lending to hedge funds and other non-bank financial intermediaries should be dealt with. On this the Group proposes that, in the case of banks which conduct proprietary trading and are owners or operators of hedge funds, an appropriate capital requirement should be enforced. In our view, such a proposal is certainly a step in the right direction. However, clear proposals are lacking on how commercial banks' lending relationships to the shadow banking system can be prevented or at least so strictly limited that the spread of problems from the shadow banking system to the normal banking system can be avoided.

On 6 May 2009, the European Parliament approved a tightening up of banks' capitalisation, which is supposed to be adopted in the member states by 31 October 2010 and come into force by the end of the year (European Parliament 2009; Stichele 2009). More specifically, it was laid down that banks may allocate no more than 25 per cent of their capital to one client or group of clients.[8] It was also agreed that, in the case of securitisations, a retention of at least 5 per cent should apply. Criteria were also more clearly defined for the »duty of care« in the valuation of securitisations.

In July 2009, the European Commission presented proposals for the further tightening up of financial institutions' capital holdings (Europa Press Releases 2009a). A consultation process then commenced on the proposals, which was concluded in September 2009. The key elements of the Commission proposals are as follows:

8. In future, balance sheet capitalisation can only include up to a maximum of 35 per cent of capital subject to withdrawal.

1. In the case of re-securitisations, banks should be subject to higher capital requirements.

2. The new provisions are to tighten up disclosure requirements with regard to securitisation risks. Accordingly, banks must clearly identify and publish risks related to securitisations.

3. Capital requirements for the trading book are to be modified in such a way that the banks take full account of potential losses which could occur as a result of unfavourable market developments in stress situations, such as those encountered in 2008 and 2009. The trading book includes all financial instruments held by a bank in order to resell them in the short term or in order to cover other instruments in the trading book, that is, essentially the bank's proprietary trading.

4. Banks' remuneration policy and practice are to be designed in such a way that an excessive willingness to take risks is neither encouraged nor rewarded. Banking supervisors can sanction banks which do not comply with the new provisions.

The European Commission's proposals are disappointing with regard to bank capitalisation. Although higher capitalisation is implicitly proposed in the case of banks' proprietary trading, including re-securitisations, it is not sufficient. It would be much better to tightly restrict banks' proprietary trading. The banks' banking book, which should include longer-term planned investments, such as receivables from loans or securities and thus the banks' core business, is not even discussed with regard to capital adequacy. No general increase in bank capitalisation is provided for, nor the introduction of countercyclical elements with regard to capitalisation, in particular including banks' banking book. Commercial relationships with non-bank financial intermediaries, such as hedge funds and commercial banks, are not addressed and play no role with regard to capital adequacy obligations. The European Commission's proposals with regard to capitalisation fall far short of the ideas contained in the De Larosière Report. As things stand at the moment, no far-reaching reform measures are to be expected from the European Commission with regard to bank capitalisation. Having said that, it can be seen that the subprime crisis and its consequences have kick-started a Basel III. The defects of Basel II are so deep that even its developers are discussing reform. The Basel Committee will give its opinion on a Basel III in April 2010. The European Commission will then make its own comments.

There can be no objection to disclosure obligations with regard to securitisation risks and the supervision of banks' remuneration policy and practice, but these are »soft« areas of regulation which, although important, are not sufficient.

3.3 Stricter Regulation of Rating Agencies

With regard to rating agencies, the De Larosière Report demands that their licensing and supervision be transferred to a reinforced European supervisory institution, the Committee of European Securities Regulators (CESR). Rating agencies' business models and financing, as well as their combination of valuation and consultation activities are to be subjected to fundamental examination. Specific provisions must be introduced for the rating of structured products. Finally, the use of ratings in financial provisions should be severely restricted (De Larosière Report 2009: 23).

With regard to the regulation of rating agencies, reform measures were instigated at the EU level. In November 2009, a Regulation on the subject was issued (Official Journal of the European Union 2009; European Parliament 2009a). The key points of the Regulation are that rating agencies headquartered in the Community will have to register with the European supervisory authority, the CESR. The rating agencies are regulated by the competent authority of the respective member state of origin, in cooperation with other member states. It is under consideration to include the CESR in this system. Furthermore, under the new Regulation, rating agencies are forbidden to issue ratings for a given company or involved third parties if they are also providing it with consulting services. The rating of financial instruments may only take place on the basis of well-founded information. There must be annual transparency reports on the rating agencies' fundamental assumptions, models and methods. Structured products must be specifically designated by rating agencies. With regard to the internal control of rating agencies, there must be at least two independent members on the administrative or supervisory board of agencies, who are remunerated independently, serve a one-off maximum term of five years and may be dismissed only on the grounds of professional impropriety.

At least one member must be an expert on securitisation and structured financial instruments.

The EU Regulation falls short of the De Larosière Report on one important point. In the latter, the supervision of rating agencies by a reinforced European supervisory institution was envisaged. In the Regulation, supervision remains a matter of national regulation. The financing of rating agencies by the company issuing the securities to be rated was not changed, either. As a result, a key element of the dependency of rating agencies remains, which is a clear instance of moral hazard, affecting their rating activities.

3.4 Initiatives on Derivatives Trading and Securitisation

The De Larosière Report proposes with regard to derivatives markets that OTC derivatives be simplified and standardised (De Larosière Report 2009: 29). It remains an open question, however, how this is to be done. For CDSs, which are regarded as particularly dangerous, the Report proposes a well-capitalised central clearing house for the whole EU. The clearing house should be supervised by the European supervisory authorities, including the ECB. With regard to securitisation, it is proposed that all issuers of securitised products must retain a significant portion of the underlying risk, which is not insured by hedging, for the entire lifetime of the instrument (De Larosière Report 2009: 29). As in the case of capital adequacy, the proposals of the De Larosière Report are fairly far-reaching. It would have been more consistent, however, if the Report had called for a state-supervised clearing house for all derivatives transactions. One defect of the Report is that it did not propose the introduction of a financial MOT.

After the first draft in July 2009 and consultations (Stichele 2009), in October 2009 the European Commission presented proposals on the regulation of derivatives markets based on the De Larosière Report and consultations with interest groups (Europa Press Releases 2009). The proposals are in line with the G20 declaration in Pittsburgh. In order to rule out regulatory arbitrage and to ensure globally coherent policy approaches the Commission is willing to cooperate with authorities from all over the world, before finalising its legislative proposals. Draft bills should be presented in the course of 2010. The key points of the Commission proposals are as follows:

1. Risk of default is to be prevented. For that purpose, legal provisions should be put forward to establish common safety, regulatory and operating standards for central clearing houses (central counterparties). The collateralisation of OTC transactions is to be improved. Capital requirements with regard to OTC transactions are to be significantly increased in comparison to transactions carried out through a central clearing house. For standardised contracts, clearing through a central counterparty is to be made mandatory.

2. Operational risk is to be reduced. For that purpose, the standardisation of contract conditions and contract management is to be actively pursued.

3. Transparency is to be increased. Market participants are to be obliged to enter positions and transactions which are not carried out through central clearing houses in transaction registers, which are to be regulated and supervised. Transparency will also be enhanced by the fact that standardised derivatives transactions may only be carried out via organised trading centres. All derivatives markets are to be covered, including commodity derivatives.

4. Market integrity and supervision are to be improved. Existing regulations against market manipulation and so on are to be extended to derivatives. Regulatory authorities are to be given the possibility to set position limits.

The intentions of the Commission, which were characterised by Charlie McCreevy as »a paradigm shift away from the traditional view that derivatives are financial instruments for professional use and thus require only light-handed regulation« (Europa Press Releases 2009), are largely identical to the proposals of the De Larosière Report.

However, it would have been better if the Commission had proposed that all derivatives transactions be carried out through organised clearing houses. The idea of a financial MOT was also left out, as it was from the De Larosière Report. However, only a financial MOT can end the pursuit of a succession of new structured products which in many areas are intransparent and of no benefit for economic development.

4 What Next?

Taking the De Larosière Group's Report as a starting point, it is fair to say that, while the proposals with regard to a European financial market supervision, the capitalisation of banks and the regulation of derivatives markets are a step in the right direction, they fall far short of ensuring the long-lasting stability of the financial system. In particular, the segmentation of financial market supervision in the EU and the design of the committee that is to supervise macroeconomic financial market stability are unsatisfactory. As far as the banks are concerned, one would have wished for tighter restrictions on banks' proprietary trading, the business relations of commercial banks with the shadow banking system and a commitment to a financial MOT.

Previous Regulations at the EU level and the European Commission initiatives mentioned in this article represent a marked and unacceptable dilution of the demands of the De Larosière Report. Furthermore, the Council's stance again falls short of the Commission's proposals. Proposals which were a lot closer to those of the De Larosière Report would have been much better, notwithstanding the fact that the latter is hardly a radical document itself (see overview in Table 1).

What next? First, it should be emphasised that even the Commission proposals watered down by the Council represent an improvement of the status quo. There is not a single area in which existing provisions are relaxed. The planned new authorities have the sole purpose of preventing the inadequate application of European regulations at the national level. Further, stricter rules at the national level, such as the »dynamic provisioning« – a countercyclical loan provisioning measure – stipulated for commercial banks in Spain before the crisis, remain possible. It is also conceivable in principle that the single-currency states agree among themselves on separate, stricter rules for their financial institutions.

However, strongly integrated financial systems are only ever as stable as their weakest systemically important element. Different degrees of regulatory stringency within the single European market in effect encourage regulatory arbitrage. Sustainable stabilisation of the European financial system by means of nation-states going it alone simply will not work.

The question for the European Parliament is whether it accepts the proposals now on the table or insists on stricter rules and a more coherent supervisory structure. When this translation of this study was being completed (beginning of May), it became apparent that the Parliament's ECON Committee would suggest a large number of changes to the present draft legislation. Since the results of the voting in the Committee are not yet available and the concluding readings and votes have not yet happened in Parliament, there is no analysis in this study of the Parliament's proposals. It is clear, however, that a large number of proposed changes, or changes that are particularly far-reaching, could delay the whole legislation on a European supervisory architecture and stricter regulations because, besides a second reading, a conciliation procedure could also be necessary. This would make it difficult to get the regulations finally adopted by the end of 2010. The danger here is that such a delay might be a tough sell to the voters. Weighing up the pros and cons of the various strategies, the best option would probably be for the Parliament to take a tough line. First of all, there is no need for undue haste, at present. A new financial crisis is unlikely to unfold over the months or year which would be needed to establish the new supervisory structure. Second, there is the danger that the adoption of new laws would result in the creation of permanent unsatisfactory structures which, not least on account of the particular interests of the new supervisory personnel, will be almost impossible to change at a later date. It is therefore important to design these structures and regulations rationally from the outset and simply to accept a certain delay in their implementation.

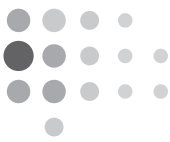

Table 1: Overview of the state of financial market reform in the EU

Regulatory area	De Larosière Group proposal	State of the debate with regard to EU legislation*	Comment/assessment
Microprudential Supervision	– Three EU supervisory authorities: for banks, insurance companies and securities – Network of EU and national authorities – »Breakthrough rights« at the EU level with regard to national authorities – Supervision of pan-European financial institutions by EU authorities	**Commission proposal:** Like the De Larosière-Group, but: – limited breakthrough rights for the EU authorities – direct supervision only of clearing houses, rating agencies, etc. **Council proposal:** Like the Commission, but: – no authority to issue directives for the European Commission in relation to national authorities – direct supervision only of European rating agencies – implicit veto of member states with regard to decisions of the EU authorities	– An integrated supervisory authority for all parts of the financial sector would be preferable – Dilution of breakthrough rights by the Commission and Council proposals is unacceptable
Macroprudential Supervision	– Introduction of a European Systemic Risk Board (ESRB) to monitor macroeconomic stability – Strong weighting of central banks in the ESRB	Like the De Larosière Group	– Weighting of central bankers in the ESRB should be urgently reduced – Outsiders (academics etc.) should be included in the process
Capital requirements	– Increase in capital requirements – More equity capital for securitisations – More equity capital for off-balance sheet obligations – Uniform definition of equity capital – More equity capital for proprietary trading – Prevention of procyclical effects of equity capital provisions	– Equity capital requirements for re-securitisations are increased – Equity capital requirements for proprietary trading increased	Improvements necessary: – Capital requirements for proprietary trading insufficient – No adequate capital requirements for loans to the shadow banking system – So far, no solution for the problem of procyclicality
Derivatives trading	– OTC derivatives are to be simplified and standardised – There is to be a well-capitalised central clearing house for CDSs	– Promotion of the standardisation of contract conditions and contract management – Promotion of a central clearing house for standardised contracts – Transaction register for OTC transactions	Improvements necessary: – Central clearing house should be made binding – Derivatives should be standardised via a financial MOT

Regulatory area	De Larosière Group proposal	State of the debate with regard to EU legislation*	Comment/assessment
Rating agencies	– Supervision at the EU level – Supervision of business and financing models – Prohibition of simultaneous consultation and ratings for the same client – Binding provisions for the rating of structured products – Restriction of the use of ratings in financial provisions	– New transparency provisions – Prohibition of simultaneous consultation and ratings for the same client – Registration obligation with regard to EU supervisory authorities	Improvements necessary: Adoption of the proposals of the De Larosière Group
Financial MOT	Not envisaged	Like the De Larosière Group	Introduction urgently recommended; for guidance, refer to the procedure for drug approval

* Unless noted otherwise, Commission proposal.

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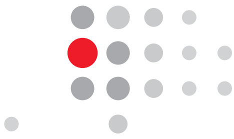

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