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An Oversight of Selected Financial Reforms on the EU Agenda

Towards for a Progressive European Response to the Financial Crisis

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1 Introduction

"What is sorely missing is any real discussion of what function our financial system is supposed to perform and how well it is doing that job – and, just as important, at what cost"[1]

Prof. Benjamin Friedman, Harvard University

This working document provides an overview of some important decisions and discussions about the reform of the financial sector which still needs to take place at the level of the European Union (EU) from September 2009 onwards. Most of them were already announced in the Commission Communication of 4 March 2009 for the Spring European Council, 'Driving European Recovery' [2]. This working document does not deal with the rescue packages of banks and insurance companies, nor with the stimulus to deal with the economic crisis that resulted from the financial crisis.

The decisions about financial sector reforms at EU level are important because they transform political agreements, such a at the G-20, and international standards such as by the Basel Committee on Banking Supervision, into legal obligations that are subject to supervision. At the EU level, this is mostly done by adopting EU directives that are subsequently transposed in national level laws of EU member states. At the national level, EU member states can still make financial sector reforms about particular issues or impose higher standards.

More than a year after the European Central Bank started to heavily intervene in the financial markets (August 2008), and after many political meetings at the highest level, many financial sector reforms that should tackle the causes and further continuation of the severe financial crisis and avoid another crisis to occur, many reform proposals are in the still in the course of a long process of decision making. Some of the proposed reforms on the table are already leading to heated debates, for instance those relating to Hedge Funds and speculation through derivative trading.

Many EU financial reforms in the making are important to guarantee more financial stability but those described in this document focuses on those issues that are important for civil society in EU member states. The financial reforms discussed in this document relate to :

- financial innovation and derivatives, namely : additional capital requirements for complex and destabilising products, regulation of "alternative" investment funds such as hedge funds & private equity funds, and make trading in derivatives safer
- measures to tackle tax havens, tax evasion and efficient taxation, through: amendment of the Savings Taxation Directive, cooperation in the area of taxation among EU members and with third countries, a financial transaction tax will be proposed
- Whether banks will become more at the service of a sustainable society when dealing with: responsible lending and borrowing in the EU, Deposit Guarantee Schemes
- Reforms of the structure to supervise the financial sector operating in the EU through: new supervisory bodies at the EU level, a review of the Financial Conglomerates Directive

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[1] "Overmighty finance levies a tithe on growth", in The Financial Times, 28 August 2009, http://www.ft.com/cms/s/0/2de2b29a-9271-11de-b63b-00144feabdc0.html

[2] Document (COM(2009) 114, http://ec.europa.eu/commission_barroso/president/pdf/press_20090304_en.pdf

Each description of an EU financial reform initiative in this document provides some preliminary critical comments not only from a perspective whether financial stability will be more guaranteed but also by looking in how far the financial system is being reformed towards better financing of a more social and environmental friendly activities rather than being at the service of the financial sector itself, speculators and those making money from money. However, this paper should not be seen as a comprehensive critique of the financial reforms being described. Indeed, much more could be said about the narrow analysis of the financial crisis on which the reform proposals from the European Commission are being based. This documents provides some critical assessments of the proposed reforms that indicate the many limitations and shortcomings that need to be discussed and taken into account when final decisions are made.

This working document will be update in the light of meetings and proposals being made in the run up of the G-20 meeting on 24-25 September 2009. Comments are welcome and can be addressed at: m.vander.stichele@somo.nl

2 Financial innovation and speculation

The financial crisis has revealed that complex, intransparent and speculative financial products, which were considered to be important innovations of the financial system, triggered and reinforced the huge instability in the financial markets. Moreover, the speculative innovations were in different ways linked to the real economy and their failures resulted in a lack of lending (credit crunch) and other negative effects, which resulted in the economic crisis.

Quite some initiatives at the EU level to prevent these innovative and speculative instruments from risking financial instability as well as many disservices to society as a whole, still need to be decided. In general, the proposals on the table try to make complex, new and speculative financial products somewhat less risky for the financial system. One decision the EU has already taken is the directive to improve the functioning of credit rating agencies.

2.1 Different stages to amend the Capital Requirements Directive (CRD)

Background

The financial crisis has been mostly seen as being triggered by the way US sub-prime mortgages. They were being lent in an risky way and then those sub-prime mortgage loans being sold off and risks transferred away from the lending banks through securitisation (Collateralized Debt Obligations/CDOs, often based in tax havens) and credit default swaps (a kind of derivative: see annex). Those complex and intransparent financial instruments were bought by banks and insurance companies and speculators (e.g. Hedge Fund) who also engaged in a lot of speculative financial products that were being sold and resold, e.g. re-securitisation and derivatives, based on the complex sub-prime mortgage financial products. The risky lending led to a real-estate bubble in the United-States and then increasing defaults by the poor lenders from the first quarter of 2007 onwards. In the pursuit of short-term capital gains, they had largely overlooked the risks associated with their financial investments. As a result many engaged in the complex financial products and speculation based on sub-prime mortgages were unable to pay for their obligations, in other words “toxic assets" were spread throughout the financial system. Banks distrusted each other as they could not know how far other banks could fulfil their payment obligations, and stopped lending to each other. Due to their high exposure to such bad assets, many banks and insurance companies had to be recapitalized by public authorities in order to avoid default which would have led to a collapse of the financial system. Taxpayers’ money was therefore used to save banks that took imprudent risks while it did not prevent the crisis being transferred to the real economy so that tax payers’ jobs and purchasing power are being affected.

It became clear that the banks were using “credit securitisation” and moved loans off their balance-sheet through special purpose vehicles mostly based in tax havens, to circumvent prudential rules on capital reserve requirements which are normally needed to ensure that lending banks are not going bankrupt when many borrowers default on their loans, and to cover other risks. Therefore, one of the financial reform proposals is to increase capital requirements so that the money reserves held by those making loans and holding payment obligations based on risky financial products are being increased. However, by requiring more capital reserves, the banks have stopped lending to each other and have diminishing their lending to (small) companies and citizens, which again squeezed the economy, leading to less economic growth and resulting in more defaults on loans.

The standards for capital reserve requirements and for risks assessment mechanisms that calculate how much relevant capital needs to be put aside for which loans, are internationally being set by the Basel Committee on Banking Supervision[3]. These non-binding international standards that are currently exist, are called "Basel II"[4] and have been reviewed[5]. In order to become legal obligations and to be subject to supervision, these standards have to be translated into EU directives and transposed in national level laws of EU member states. The existing EU Directive on Capital Requirements was formally adopted by the Council and the European Parliament on 14 June 2006[6].

Decision making process to review the Capital Requirement Directive (CRD)

The EU decision making is currently in three different processes to review the existing CRD and related issues of too risky lending and bank practices.

Kind of initiative	Date of issue	Consultation	Content	Decision-making	Website	Application
1. Agreed directive by the Council and EP	October 2008	Took place in 2008	better capital requirements for securitization, limits on bank-to-bank lending, colleges of supervisors for all big large cross-border banks	May 2009;by end of 2009: review of rules on procyclicality, leverage and methodologies	http://www.europarl.europa.eu/pdfs/news/expert/infopress/20090505IPR55119/20090505IPR55119_en.pdf	Transposisition of the new CRD at national level by 31 October 2010 and application from end 2010
2. Legislative proposal	13 July 2009	End of consultation period: 29 April and 6 May 2009	capital requirements for re-securitisation, assessment of short term risks, more info on risks from securitisation, supervision of remuneration policies	ECOFIN & EP (econ): discussions in autumn 2009 and voting for adoption expected end of 2009	http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#consultation	After decision by ECOFIN and EP
3. Public Consultation to prepare further	24 July 2009	End of consultation period: 4 September	through-the-cycle expected loss provisioning; more capital	Adoption of legislative proposal by EC in	http://ec.europa.eu/internal_market/cons	

[3] For more information, see amongst others: http://www.bis.org/bcbs/: the Basel Committee on Banking Supervisors was until June 2009 comprised of central bankers from the 13 biggest industrialized economies.

[4] http://www.bis.org/publ/bcbsca.htm: The USA still has not fully implemented the principles set out in Basel II <http://www.financialstability.gov/docs/regs/FinalReport_web.pdf>

[5] http://www.bis.org/publ/bcbsca.htm: on 13 July 2009, the Basel Committee issued a final package of measures to enhance the three pillars of the Basel II framework and to strengthen the 1996 rules governing trading book capital. All the proposed measures are to be implemented no later than 31 December 2010.

[6] The CRD comprises : (1) Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, and (2) Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

possible changes to the Capital Requirements Directive.		2009	requirements for housing loans denominated in a foreign currency, removal diverse implementation of CRD, and less reporting requirements for branches	October 2009, after which it is to be adopted by ECOFIN and EP (Econ)	ultations/2009/capital_requirements_directive_en.htm	
Start of a legislative process to stop excessive balance sheet growth	Possibly autumn 2009	public consultation and impact assessment	restrain excessive and unsustainable balance sheet growth through a leverage ratio measure; inclusion of current work done by Basel Committee on Banking Supervision	Adoption by EC likely in Autumn 2009 for adoption by ECOFIN and EP (Econ)	http://ec.europa.eu/internal_market/consultations/docs/2009/capital_requirements_directive/CRD_consultation_document_en.pdf	

1. The main elements of the first to review the CRD, decided in May 2009

- Making **securitisation** safer and limit the use of securitization: banks have to retain 5% of the securitised products they originate and sell (a retention rate of 5%).[7]
- Limiting large inter bank exposures: there is a cap on how much a bank can lend to another bank[8].
- Setting up colleges of supervisors for all big cross-border banks. This should allow national regulators that oversee operations across the EU to meet regularly to share information and spot any problems early.

2. Main elements of the legislative proposal to further review the CRD, presented in July 2009[9]

- Increased capital requirements for **re-securitisations** (securitisation or repackaging of existing securitised debt obligations into new securities): in case a bank cannot demonstrate that it complies with the requirements for due diligence, it is proposed to substantially increase the retention rate related to the position of that re-securitization.

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[7] More precisely, the measure consists in ensuring that "*an institution issuing an investment retains a material interest in the performance of the proposed investment. The retention rate is at least 5% of the total value of the securitised exposures*", http://www.europarl.europa.eu/news/expert/infopress_page/042-55120-124-05-19-907-20090505IPR55119-04-05-2009-2009-false/default_en.htm

[8] More precisely, according to the agreed text, a bank would not be able to expose more than 25% of its own funds to a client or a group of clients. Exceeding this threshold will only be possible for exposure between credit institutions and for not more than Euro 150 million. A review clause was also agreed, as requested by the MEPs, on the large exposure regime by end of 2011, also to seek further harmonisation of national provisions, in European Parliament, http://www.europarl.europa.eu/pdfs/news/expert/infopress/20090505IPR55119/20090505IPR55119_en.pdf

[9] European Commission (2009) Proposal for a Directive amending directive 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitizations, and the supervisory review of remuneration policies

- Strengthened disclosure requirements on how much banks e.a. are exposed to risks from securitization in which they are involved.
- Banks will have to assess the risks connected with their **trading books** to ensure that they fully reflect the potential losses they can incur from adverse market movements in times of financial markets turmoil or crisis (as was the case in 2008).
- Financial firms should have a remuneration policy or banking supervisors shall be given the power to sanction financial firms with no remuneration policy. The firms would remain responsible for the design and application of their particular remuneration policy since the EC proposal does not prescribe the amount and form of remuneration.

3. Consultation starting the process for a CRD third review covering some other aspects for, issued on 24 July 2009[10]

The main elements of the staff-working document that is used for the open public consultation are:

- Credit institutions should build capital reserves during the good times and use these provisions to cover losses during bad financial or economic times ('through-the-cycle expected loss provisions' for credit risks): such provisioning of capital reserves should be applied to items on the balance sheet (such as loans) and possibly to off-balance sheet items (such as guarantees). It would allow for timely capturing expected losses due to inherent credit risks, which have however not yet materialised. It would different from existing capital requirements which basically provide a capital buffer for unexpected losses. This would essentially be "a countercyclical measure" and not be considered as required regulatory capital reserves.[11] The overall approach is more-or-less based on the existing Spanish model.
- **Credit institutions will have to fulfil specific incremental capital requirements** for housing mortgage loans denominated in a foreign currency: additional capital requirements are needed to cover the risks of a change in foreign currency that might increase the repayment burdens on private households for their "residential real estate" with mortgages denominated in foreign currencies, as happened in many Central and Eastern European countries.[12] The Commission considers to introduce specific and penal capital requirements to discourage credit institutions from granting foreign currency loans to private households or loans for residential property that are denominated in a currency other than that of the income of the borrower.[13]
- **The removal of national options and discretions in the application of the CRD at national level by the member states**, regarding regulatory additions on issues that are regulated by EU directives: the EC aims at maximum harmonisation whereby no additional requirements may be set at national level.

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[10] http://ec.europa.eu/internal_market/consultations/docs/2009/capital_requirements_directive/CRD_consultation_document_en.pdf

[11] http://ec.europa.eu/internal_market/consultations/docs/2009/capital_requirements_directive/CRD_consultation_document_en.pdf: The methodology should be formula driven, based on agreed rules and automatic triggers, largely non-discretionary and applicable both at individual and consolidated level.

[12] http://ec.europa.eu/internal_market/consultations/docs/2009/capital_requirements_directive/CRD_consultation_document_en.pdf: This is a particular concern in relation to housing loans because these loans usually are well in excess of households' liquid assets and may constitute a large portion of the value of the residential property being financed

[13] In case of foreign currency loans for private housing, a significant incremental capital requirement should be applied when the loan to value ratio is in excess of 50 % and should lead to a full one to one backing by capital requirements as the loan to value ratio reaches 100% and beyond. This is especially the case where such loans exceed a low and conservative ratio of value of the loan to value of the property and where the private household does not hedge the foreign exchange risk or possess a stable and sustainable source of sufficient and freely available income denominated in the relevant foreign currency which is deemed by a credit institution following appropriate stress tests to service the foreign currency borrowing on an ongoing basis.

- **The simplification of the Bank Branch Accounts Directive**[14] by prohibiting any member state to require that branches of banks or other credit institutions with their head offices in other Member States, to publish additional information than those required from the credit institution established in other Member States.

Some comments, criticisms and alternative proposals

1. Main deficiencies of the first revision of the CRD

- The 5% retention requirement related to securitization is too low to effectively just make securitisation less destabilising for the financial system. The retention provision was the most discussed and substantial element to promote a more prudent risk profile regarding securitization. EC originally proposed that financial firms should retain 15% of the securitised products they originate and sell. However, due to strong opposition from banks, the EC give in to the lobby pressures had to side back and the agreement approved by the European Parliament and the Council last May was on a retention rate of 5%. However, the European Parliament requested and obtained "a strong review clause, asking the Commission to come up with a possible proposal to increase the retention rate, by 31 December 2009, after consulting the Committee of European Banking Supervisors and taking into account international developments".[15] This provides still an opportunity for public and political pressures for change. In order to limit securitisation, banks should at least be required to take a bigger share of the risks associated with the securitised products they sell for instance through a much higher retention requirement.
- Beyond the debate on the level of retention required, a more efficient way to limit drastically securitization and, by the same token, the capacity for banks to bypass prudential rules, would be to compel them to limit drastically the share of their credit portfolio that can be securitized. Also other measures should discourage banks from using securitisation and transferring risks in order to make more and more profit.
- The first proposals in the first CRD review did not allow for a more coordinated EU supervisory system and there are many doubts over the efficiency of this college-based oversight. The proposals to review the supervisory structure (see below), only partly address those concerns.

2. Main deficiencies of the legislative proposals for second revision of the CRD proposed on 13 July 2009

- The EC proposals mainly aim at "creating a climate of market confidence", they mainly create a safer environment to make use of (re-) securitization, which stimulates the use of those risky complex products and related financial speculation. A more radical reform of the market should introduce much stronger rules to stop risky financial engineering such as re-securitisation since when the opaqueness, complexity and sheer volume of re-securitisation can put the financial system at risk or requires enormous amounts of increased (expensive) supervision which are currently not possible.
- The use of off-balance-sheet vehicles, through which securitisation processes were taking place, is legitimated as a practice in this directive, which undermines the aims of this directive

[14] Directive 89/117/EEC
[15] http://www.europarl.europa.eu/pdfs/news/expert/infopress/20090505IPR55119/20090505IPR55119_en.pdf

since off-balance sheets are used to circumvent reporting requirements or to reduce the amount of capital they needed to hold to satisfy regulatory requirements. In order to guarantee full transparency (a key principle in all the current official reform proposals) the use of off-balance-sheet vehicles should be banned. This would oblige financial firm willing to take risks to put those risks on their balance sheet and discourage them from taking too risks high risks they are not willing to disclose. The prohibition of use of off-balance-sheet vehicles should be based on the argument that they transfers the risks to investors and the real economy in case of default.

- The proposals in this CRD review will not tackle the perverse pay incentives which have contributed to excessive short term risk-taking since they allow financial firms keep all possible flexibility to apply some general self-designed principles. Also because of competitiveness pressures, there will be a tendency to keep the remuneration standards as low as possible in order to ensure that financial firms are not leaving the country (arbitrage). This can only be prevented when the same stringent rules which prevent remuneration policies are made binding to all EU financial firms and when all European financial supervisors assess financial firms on thee same stringent rules to prevent that remuneration policies promote excessive risk taking. If not, financial firms will move to the Member States that have the most relaxed regime on remuneration while the impact of excessive risk taking is for all of Europe. The EC has made an official Recommendation[16] on remuneration policies in the financial services sector but the CRD would not make them binding on all financial firms operating in the European Union and not oblige all supervisors to use those principles. As a minimum, the remuneration criteria to assess performance should be based on longer-term performance and allow to adjust payments according to outstanding risks associated with the performance (multi-year framework), the business cycle of the company or re-valuation of performances when subsequently proven to be manifestly misstated.

3. Some comments and criticisms about the consultation for a third review of the CRD

- The proposal to put aside additional capital in good times, does not solve the problem in the current crisis by which the banks lack the necessary reserves to cover losses from increasing credit defaults during the economic recession. In addition, the EC proposes to assess whether the implementation of any of the proposed revisions for additional capital requirements should be postponed until recovery is advanced and assured. This is seen as consistent with G20 declaration 2nd April 2009, which stated that prudential regulatory standards should be strengthened once recovery is assured, and that "until recovery is assured the international standard for the minimum level of capital should remained unchanged".[17]
- The proposal does not deal with the internal risks assessment instruments that are being used by banks, which so far failed to better assess potential risks and impacts of periods of economic and financial hardship.
- The requirements for additional capital reserves for home loans denominated in foreign currencies are still having exceptions and aiming at discouraging the practice (see also the EC

[16] European Commission, *Commission recommendation on remuneration policies in the financial sector,* April 2009, < http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:120:0022:0027:EN:PDF>

[17] <http://ec.europa.eu/internal_market/consultations/docs/2009/capital_requirements_directive/CRD_consultation_document_en.pdf, p. 2.

proposal on responsible lending) rather than forbidding the practice which was also a problem during the Asian crisis (was also related to commercial real estate).

- The EC proposals to improve the application of the CSD do not intend to remove national (explicit) discretions and options in areas that are not covered by EU legislation and not fully harmonised. Therefore the EC fails to tackle the fundamental issues of national and regulatory arbitrage, i.e. that financial firms go and establish themselves in those countries where the rules and prudential requirements are lowest.
- The EC argues[18] that there is little added value in the publication of additional accounting information by branches from credit institutions established in other Member States because supervisors have enough access to the needed information. However, this does not take into account that there is a need for more publicly available information on the many different activities in the many countries in which a financial conglomerate operates. It is not clear whether this prohibition on additional information per branch would also apply regarding information on social and environmental performances of branches of banks established in another member state.

4. Some overall comments and criticisms on the CRD review

- The review (proposals) only partly deal with many of the criticisms that were made on the international standards of Basel II and its almost full transposition in the EU's directive in 2006, e.g. relating to pro-cyclicality. They fail to substantially increase banks' compulsory reserve requirements (beyond the Basel II agreements) for credit that feed speculation.
- The CRD reviews do not deal with one of the most serious criticisms of Basel II and the CRD, namely that banks were allowed to have their own risks assessment mechanisms. However, these internal risk assessment models would tempt the financial industry to assess the risks lower in order to have to retain less capital reserves and being able to make more money through more loans and attracting more clients through lower interest rates. Moreover, the internal risks assessments were heavily relying on credit rating agencies whose capacity to rate adequately very complex products has been deficient as the crisis has shown. Although some supervisory principles were agreed, supervisors had to agree with use of the internal models. In addition, the supervision of the risk models was different in the EU member states. The EC proposals does not solve the problem of arbitrage between Member States whereby weaker application rules and supervision were used to attract the financial services industry. One improvement to the internal model system for financial cross-border banks would be to have the internal risk assessment mechanism being approved by the college of European supervisors of that cross border bank. If there is a conflict in the College among national supervisors about risk assessment models, the Committee of European Banking Supervisors (CEBS) or its potential successor the European Banking Authority should have a final say on the models (see also below: revision of the supervisory structure).
- No mentioning has been made to include social and environmental risks through additional capital requirements or changes in the risk assessment mechanisms which currently are only assessing financial instability. In order to encourage financing of sustainable economic

[18] http://ec.europa.eu/internal_market/consultations/docs/2009/capital_requirements_directive/CRD_consultation_document_en.pdf: p. 14

activities, reserve requirements that support sustainable activities and employment should be set at lower level for normal loans and receive more governmental guarantees.

- Given their limited scope and limited changes required in the current CRD amendments, they will not succeed in curbing imprudent and excessive risks-taking in the banking sector. Amendments to the adopted changes as well as new review proposals will be needed to really strengthen prudential regulation.
- The EC does not make a distinction between bank activities that serve the public interest and bank activities that finance speculation (leading to a zero-sum game for the economy). So far there is no official proposal about dismantling universal banks or/and (re)-introducing a clear separation of bank types according to their public interest or business. Commercial banks should so be prohibited from lending money to investment banks or have a limited capacity to buy complex structured products from them. They would have to refocus on their original mandate which is to collect savings and provide financing for real economy needs. Similarly, investment banks would not be allowed to receive savings deposits from individuals or companies. Such a clear-cut division of labour among the banking system would prevent commercial banks from being negatively affected by the losses made by investment banks as a result of their speculative investments. However, during the financial turmoil in autumn 2008, investment banks such as Goldman Sachs have been accepted to become banks while they still continue many investment bank activities.

2.2 Proposal to regulate managers of Hedge Funds, Private Equity funds and other so-called "alternative investment funds"

Background

The EC has always agreed with the promoters of hedge and private equity funds that those funds correct market inefficiencies and keep companies alert. Because they are privately-owned and considered to be highly professional investors only dealing with professional investors, they have not been subjected to regulation or the same EU rules as financial companies and companies whose shares are traded on the stock exchange[19]. Hedge funds have grown fifty-fold in terms of assets under management since 1990. Although they account for only 5-10% of assets managed by the global fund industry, their activities are very influential on the financial markets: trading by hedge funds has accounted for over 50% of the daily trading volume in equities markets, and they have become crucial providers of liquidity and driver of price formation in global financial markets.

The AIF sector in the EU is relatively large - the AIFM managed around €2 trillion in assets at the end of 2008 - and diverse: hedge funds, private equity funds, commodity funds, real estate funds and infrastructure funds, among others, fall within this category.

The financial crisis has made many recognise that the activities of hedge and private equity funds are a threat to financial stability and the real economy, if not the cause of financial crises (by the way they pushed up financial return expectations), because they rely on huge accumulated debts called leverage (financing their activities by loans worth manifold their own assets) which made it difficult to repay their debts or obtain loans in times of financial crisis. Hedge funds have also been amongst the leading buyers and sellers of many of the credit derivative and other structured products that have been at the central in triggering the current financial crisis. A common activity of hedge funds is short-

[19] Socialist Group in the European Parliament (PES), Hedge funds and private equity – A critical analysis, 2007.

selling, which has is considered to have contributed to driving down the share prices of financial firms during the financial turmoil in October 2008. A common activity by private equity funds is the practice of buying a company, with loans to be repaid by the company itself, in order to sell the company with high profits after a short period or to sell its assets individually at a profit (asset stripping). The lack of transparency about hedge and private equity funds' activities and strategies made it difficult to assess what negative impacts they could have on the financial system. Moreover, their aim of making short term profits undermined the long-term strategy of healthy companies, ignored the interests of other stakeholders such employees and consumers. Also, they pay little tax by using aggressive tax avoidance strategies, establishing the funds off-shore and registering in so-called tax havens. Hedge funds and private equity have been heavily criticised by civil society and trade unions, and some governments and academics, for their very speculative, risky, non-transparent, financially and economically harmful activities. Nevertheless, European pension funds have been keen on the high returns that hedge funds and other 'alternative' investment funds offered during previous year and have invested in those funds for around EUR 1 trillion[20].

Hedge funds and private equity funds might create more problems in the future. A study of Boston Consultancy Group estimates that 20% up to 40% of the largest companies bought by private equity firms (leveraged buy-out companies) could go out of business within two or three years. Moreover, most private equity firms' portfolio companies are expected to default on their debts, which are estimated at about $ 1 trillion[21.] The risk of rising interest rates and a slowing down of the economy has made it difficult to service the debt and brings target companies to the edge of bankruptcy.

Decision-making on the EC draft directive on "alternative" investment funds' managers (AIFM)

In September 2008, the Parliament adopted two resolutions urging the Commission to regulate private equity and hedge funds more tightly. The EP had adopted similar resolutions in earlier years, but the EC (Commissioner Mc Greevy) had refused to initiate legislative proposals. However, in April 2009 the Commission released a proposal to regulate "alternative investment fund managers" which did not include many of the earlier proposals made by the European Parliament.

Kind of initiative	Date of issue	Consultation	Content	Decision-making	Website
Legislative proposal	29 April 2009	The consultation period preceding the legislative proposal ended on 31 January 2009	Registration and minimum capital requirements of AIFM, enhanced transparency and supervision, requirements for non EU based AIF and AIFM, facilitating AIFM to move freely across the EU	ECOFIN & EP (econ): discussions in Autumn, not sure if decisions are made at end of 2009	http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm

[20] http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/investmenttrusts/5972511/EU-rules-will-cost-pension-funds billions.html>

[21] The Boston Consulting Group, IESE Business School, "Get ready for the private-equity shakeout?`, December 2008.

The proposal is extremely controversial and being criticised for being too weak as well as being so strong that it would eliminate the speculative financial operators covered by the directive. The UK, where the majority of the Hedge fund industry is based, and Sweden, who holds the EU presidency in the second half of 2009, have already openly declared to propose to weaken the EC proposals to defend their financial industry in this areas. However, the review of financial regulation and supervision by Lord Turner of the UK's Financial Services Authority[22] advocated extensive information gathering on hedge fund activities. France and Germany have traditionally argued for strong regulation and limitations on hedge funds and private equity because they consider them to play an important role in financial crises.

Other official agencies and fora dealing with financial reforms on these issues include: the G20[23], IOSCO[24], e.a.

Main elements of the AIFM proposal[25]

The draft directive does not regulate the so-called alternative investment funds themselves but its managers. The 'alternative investment funds' are defined as all funds that are at present not harmonised under the directive on Undertakings for Collective Investment in Transferable Securities (UCITS)[26]. The draft Directive's aims to cover managers of hedge funds e.a. located in the EU with portfolios in excess EUR100 million, and managers of Private Equity funds of portfolios over EUR 500 million.

- The **main regulatory** component of the proposal is **an obligation to register and disclose information** of the activities by EU-based managers of the so-called 'alternative investment funds' (AIFM). This is considered to improve supervision and avoid systemic risks. Important information disclosure obligations by AIFM include:
  - Disclosure to regulators and investors of the **aggregate level and form of leverage**. The different competent supervisory authorities for such leveraged funds are required to aggregate, and share among supervisory authorities, information that is relevant for monitoring and responding to the potential consequences of AIFM activity for large financial operators across the EU and/or for the orderly functioning of the financial markets.
  - Disclosure of information to other shareholders and to representatives of employees of the company in which the **AIFM acquired a controlling interest** covering:
    - Information about the investment strategy and objectives of the AIFM when acquiring control of companies;
    - General disclosure about the performance of the portfolio company following acquisition of control. This information requirement address the perceived deficit

[22] "The Turner Review: A regulatory response to the global banking crisis", March 2009.
[23] The G-20 agreed that hedge funds should be registered, required to regularly disclose information to supervisors and have adequate risk management, and that supervisors should require institutions which have hedge fund counterparties to have effective risk management mechanism to monitor the funds' leverage and set limits for single counterparty exposure.
[24] In March 2009, IOSCO released detailed recommendations in a consultation report on Hedge Funds Oversight, the recommendations include that: prime brokers and banks with exposure to hedge funds should provide information on their exposure to hedge fund counterparties and have risk management controls over such exposures, hedge fund managers should be registered and supply information to regulators including on investment strategies, and risk management mechanisms and capital requirement.
[25] http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf
[26] Allows collective investment funds such as mutual funds (see Annex: terminology) to operate freely in the EU; see also: http://en.wikipedia.org/wiki/Undertakings_for_Collective_Investments_in_Transferable_Securities

of strategic information about how private equity managers intend to, or currently, manage portfolio companies;

- Reporting, up to 2 years following de-listing, on companies that were listed on the stock exchange at the time they were acquired. This information requirement intends to meet concerns about reduction in information following the de-listing of public companies by private equity owners.

- **Restrictions on the use of leverage** can be set:
  - The Commission gets the power to set[27] limits on the leverage used by AIFM where this is required to ensure the stability and integrity of the financial system.
  - National authorities are granted additional emergency powers to restrict the use of leverage in respect of individual managers and funds in exceptional circumstances.
  - According to the EC[28], the possible impact of the failure of an individual hedge fund on the banking sector is currently addressed through the prudential regulation of prime brokers.
- The proposal includes **capital requirements** for AIF manager (not the fund):
  - The AIFM (with AIF portfolios in excess EUR100 million) shall have own funds of at least EUR 125 000.
  - Where the value of the portfolios of AIF managed by the AIFM exceeds EUR 250 million, the AIFM shall provide an additional amount of own funds equal to 0.02 % of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million.
- Requirements for **marketing of third country funds**: an EU based AIFM should be able to do marketing of AIF based in a third country, including those based in fiscal havens, provided that these countries comply with "stringent requirements on regulation, supervision and cooperation", including on tax matters[29]. The rights granted under the Directive to market such AIF to professional investors will only become effective three years after the transposition period. In the meantime, Member States may allow or continue to allow AIFM to market AIF domiciled in third countries to professional investors on their territory subject to national law.
- Requirements for **AIFM established in a third country**: they will be allowed to market their funds in three years after the transposition period of this Directive, provided that the regulatory framework and supervisory arrangements in that third country are equivalent to those of the proposed Directive, and EU operators enjoy comparable access to that third country market
- **Facilitating the free movement of all AIFM within the EU**, which is the second main aspect of the draft directive: After the authorisation from the competent authority of the home Member State, a special 'passport' for fund managers would allow them to operate in other EU member states because of the principle of mutual recognition and the prohibition of other Member States to impose additional requirements.

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[27] Through comitology procedures

[28] http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/211&format=HTML&aged=0&language=EN&guiLanguage=fr: "Prime brokers are required to hold capital against their hedge fund exposures and to have in place robust counterparty risk management systems. The reform of European banking regulation is part of the comprehensive package of reforms announced in the Commission Communication on Driving European Recovery [4 March 2009]. The Basel Committee has recently started a comprehensive review of the Basel II prudential treatment for counterparty credit risk (posed by e.g. hedge funds) and the relevant disclosure provisions."

[29] The draft Directive only permits the marketing of AIF domiciled in a third country, if their country of domicile has entered into an agreement based on Article 26 of the OECD Model Tax Convention with the Member State on whose territory the AIF shall be marketed. This would allow national tax authorities may obtain all information from the tax authorities of the third country which are necessary to tax domestic professional investors investing in offshore funds.

Some comments, criticisms and alternative proposals

- The proposed directive only deals with some of the negative effects for financial instability by the AIF activities. Although critics[30] assert that AIF are useless or harmful for the economy and society, the EC proposals are not based on an assessment whether or not the activities of these AIF, which mostly engage in speculative and risky activities, are useful or desirable. Nor does the proposed directive deal with the visible negative consequences on companies and the contribution of speculative funds in increasing the gap between rich and poor. In this way, the EC failed to tackle major instruments of financialisation of the economy rather than putting finance at the service of the economy and society. Even within their own limited scope of avoiding financial instability, basically through more transparency and some financial requirements, the EC proposals might fail to achieve their aim as more comprehensive comments below explain. Nevertheless, many arguments are made by proponents of AIF that this proposal is too far reaching, too costly and too restrictive on the AIF industry and its clients. Questions are also raised whether the regulations will really be applied and whether supervisors would have enough capacity. In addition, the EC continues to adhere to the free market principle in financial markets by facilitating the free movement of AIFM throughout the EU.

- According to Poul Nyrup Rasmussen, who was the rapporteur of the European Parliament own initiative reports on hedge funds and private equity, has identified 10 big holes in proposal for a directive:
  1. The proposal covers **only EU-based fund managers** (not the funds themselves, and not managers based elsewhere)
  2. The registration proposed is a formality with **no real requirements**
  3. It sets a **threshold of €100 million for hedge funds and €500 million for private equity, which will herald a golden age for fund managers and "consultants" to collude in circumventing the threshold.**
  4. The **capital requirements are miniscule (additional capital of 0.02% is required when the portfolios of the manager exceeds EUR 250 000 000)**
  5. **Transparency is inadequate** in terms of information to be provided and frequency of reporting
  6. There is **no real disclosure of portfolio companies**
  7. **Nothing on market disruption by non-EU funds**
  8. **No regulation of naked short-selling**
  9. **No specific protection of institutional investors**
  10. **Nothing on tax evasion**

- Hedge Funds and Private Equity funds are already extremely heavily lobbying to defend their interests against this EC proposal and argue that stricter regulation would drive financial firms out of Europe and increase the costs for their clients (e.g. pension funds) who are joining them in their lobby. Also, the conditions put on the AIF and AIFM from outside the EU is being used to build a broader coalition for lobbying against the proposal.

- A major point of criticism is that the so-called alternative funds themselves are not covered by this draft directive, except for the delay to market third-country funds. This would have been necessary to address issues such as capital reserves and liquidity requirements more easily. Rather, all privately-owned funds it should be regulated.

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[30] See for instance: G. Parker, Art ."London watchdog chief backs global tax", in The Financial Times, 27 August 2009.

- The proposed Directive does **not regulate many AIF managers** because: (1) it does not regulate AIFM outside the EU and (2) sets a threshold under which EU-based AIF managers are not subjected the proposed requirements which can easily leave out many managers namely hedge fund managers whose portfolio's do not exceed EUR 100 million and private equity managers with portfolios less then EUR 500 million. As a result, the proposal covers less than a third of hedge-fund managers. At least, all AIFM operating in the EU should be regulated by a directive.
- **The investment policies of AIFM are not regulated**: The EC reasons that professional investors know the risks to which they are exposed and that regulation would be unnecessarily restrictive. The EC does not propose to stop investment strategies and activities that destroy healthy companies or have negative societal effects (social, environmental). The disclosure obligations to other shareholders and to representatives of employees of companies they control, will not solve all the problems. The directive proposal fails to deal with the following harmful investment policies, amongst many others:
  - **short selling** (see annex: terminology): the EC has announced that abusive short selling is subject to the review of market abuse directive. This means that the EC will not make proposals to regulate or forbid 'non-abusive' short selling and short selling which results in very negative impact on the sustainability of a company (e.g. Fortis). At least, naked short-selling and/or speculative short selling should be forbidden.
  - **lending of shares**: the proposal does not regulate this important instrument for short selling which results in 'empty voting' whereby the lender of the share, and not the owner, votes on the shareholders' meetings.[31] The practice of empty voting should be banned and it should no longer be possible to lend voting rights, via securities lending, just before companies general meetings to exercise influence on a company's because the lenders do not carry the economic risk associated with the decision taken.
- **The remuneration system for AIFM** and for the management of the company they target or control: the current fee structure and remuneration incentives currently promote excessive risk taking and does not takes into account aspects of long-term profits nor social and sustainable strategies. At least the AIFM directive should make the principles set out in the EC's (non-binding) Recommendation on remuneration policies in the financial services sector, fully apply in a binding manner to the AIFM covered under the directive.
- **The use of tax evasion and tax avoidance mechanisms including abuse of tax deduction and tax incentives** : The directive should prohibit that private equity funds can load the debt, incurred for buying a company, on that company's balance sheet and still get a tax deduction for paying their debts. The proposed directive could also contain more measures to apply adequate taxation of capital gains and fees of managers and to curb tax evasion, e.g. by prohibiting the use of investment vehicles by investors for tax avoidance purpose and by prohibiting speculative AIF funds that are located in tax havens to have access European markets. Now, the draft directive would continue to allow IAF based in countries regarded as tax havens (after three years) as long as these countries comply with international standards

[31] http://www.minfin.nl/dsresource?objectid=34851&type=pdf: in 2007, the EC intended to make recommendation about 'empty voting' at the time it was making proposals for the directive on shareholders rights.

for exchange of information (an agreement based on Article 26 of the OECD Model Tax Convention)[32].

- **Very limited restrictions on leverage**: The proposals only try to make AIFM activities less able to cause financial instability in case of shortage of money on the financial markets or in case of financial crisis, by providing the possibility to set leverage limits through empowering the Commission and national competent authorities. However, a range, with a minimum and maximum, should be determined by the Directive to limit the room of manoeuvre of the EC and national authorities. This would avoid setting too weak leverage restrictions and as well arbitrage between EU member states. Therefore, criteria should also be defined in the directive regarding the emergency measures by which the competent authorities of the home Member State may impose additional limits to the level of leverage that AIFM can employ.

- **Low capital requirements**: the EC argues that stringent and higher requirements are not necessary as there would be no systemic risks. This contradicts with the view many critics and analysts of the current financial crisis that leverage leads to systemic risks and stringent capital requirements for privately-owned funds are necessary to prevent systemic risks. Moreover, the EC considers[33] that the use of leverage by investment banks is higher and riskier that therefore use of leverage by hedge funds should not be considered as a threat! Rather, what should be argued for, is that the proposed legislation should oblige AIFM as well as hedge funds and equity funds to hold much more capital in reserve to cover their potential operational losses. This would at the same time seriously limit their use of leverage.

- **Additional check and balances mechanisms should be integrated in the directive:**
  - The proposed directive should also include a measure ensuring that institutional investors (Banks, Insurance Companies, Pension Funds) can only invest in AIF funds complying with the directive.
  - The **practices of prime brokers and investment banks** link AIF with the real economy and the financial stability of the financial system, among others by providing the loans used in the leverage to AIF and all kind of financial services and advice to AIFM. Since they are also highly leveraged themselves, they should be subject to higher capital requirements when prudential regulation on prime brokers is being reviewed at EU and international level[34]. Investment banks also have clear conflicts of interests as they intermediate between hedge funds, institutional investors and design financial products in which those third parties invest. However, the guarantees that the various roles of

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[32] McCreevy had put it this way in his speech "The future of regulation", at the Reform Scotland's Spring Lecture, Edinburgh, 13 May 2009: "We shall also make the EU-wide marketing of funds from third countries conditional on their effective regulation and supervision, including as regards their taxation. So we are not – as some ill informed or ill-intentioned people have said – opening our doors to funds from "tax heavens". Quite the contrary, we are raising the standards for the products which are allowed to be sold in the EU."

[33] According to the EC: "leverage of hedge funds is on average much lower than leverage of investment banks. While the latter use leverage ratios of up to a factor of 30 or even 50 in some cases, leverage ratio of hedge funds is down from a factor of 2 before the crisis to factor 1 in 2008, i.e. the average leverage used by hedge funds equals their net assets. These figures illustrate that the systemic risk posed by the use of leverage by hedge funds is significantly lower than that of investment banks." http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/211&format=HTML&aged=0&language=EN&guiLanguage=fr

[34] EC: "The possible impact of the failure of an individual hedge fund on the banking sector is currently addressed through the prudential regulation of prime brokers. Prime brokers are required to hold capital against their hedge fund exposures and to have in place robust counterparty risk management systems. The reform of European banking regulation is part of the comprehensive package of reforms announced in the Commission Communication on Driving European Recovery. The Basel Committee has recently started a comprehensive review of the Basel II prudential treatment for counterparty credit risk (posed by e.g. hedge funds) and the relevant disclosure provisions." http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/211&format=HTML&aged=0&language=EN&guiLanguage=fr

investment banks are clearly separated through so-called "Chinese walls" are too weak. The activities of prime brokers should be completely separated from at least all other activities of the financial firm in which they work, or strict separation between commercial and investment banks could be proposed to avoid speculative and leveraged activities to undermine banking for the general public and (small) companies.

- (European) Works Councils of Employees should have a right to (dis)approve strategic company decisions such as takeovers and overhauls in order to avoid take-overs by AIF that are only oriented to short term profits at the expense of other stakeholders and the long term interests of the company.
- Danger of competition for lower regulations (arbitrage) in order to attract AIFM, as a consequence of the 'passport' that facilitates the free movement of an AIFM authorised in one member state country to operate in another EU country managers. By setting relaxed registration requirements as well as weak regulatory and supervisory regimes, member states can attract head offices of what they see as the lucrative businesses of AIF head offices. Rather the Committee of European Securities Regulators (CESR) , or its successor body (see below: review of EU supervision) should be the authority for registration. Moreover, host supervisors may conflict with the home supervisor about the risk profile of AIF activities without having the competences to act. The proposed directive has no mechanism of binding mediation in case of conflict between national supervisors. This is also not sufficiently dealt with in the EC proposals on a new EU supervisory structure.

2.3 Proposals to make trading in derivatives safer

Background (see also annex: terminology)

Derivatives are financial instruments that are derived from some other assets, credit, foreign exchange, interest rates or commodities, the so-called 'underlying'. A derivative contract specifies the right or obligation between two parties to receive or deliver future cash flows, securities or assets, based on a future event. Derivatives can be very varied in nature and structure up to very "exotic" speculative products whose functioning and impact are therefore difficult to understand for non-insiders.

The participation in derivative markets has increased considerably over recent years (from less than $ 100 trillion notional amounts outstanding in 1998 to $ 400 trillion around the end of 2006, to almost $ 700 trillion in June 2008[35]). Apart from large financial industry actors such as investment banks and insurance companies who have been dealers, and users (sellers and buyers) of derivatives, Hedge Funds have also been amongst the leading buyers and sellers of many of the credit derivative at the same time as other (securitized) structured products that have been central in triggering the recent financial crisis. The fact that these financial actors were both active on the derivative markets as well as other financial markets allowed to crisis to spill over the whole financial system and many financial firms which had become too large to fail. A particular kind of derivative whose trade has recently increased considerably, credit default swaps (CDS), have been broadly associated with major losses during sub-prime mortgage crisis so that AIG, the worldwide insurance conglomerate based in the US, needed to be recapitalized when it emerged that the Financial Products division incurred huge losses through the payment obligations resulting from the $18 billion of CDS contracts it had engaged in/sold.

[35] EC, Staff working document - Ensuring efficient, safe and sound derivatives markets, 7 July 2009, Chart 1: the size of derivatives markets : on – and off exchange, in notional amounts outstanding

The majority of the derivatives are traded in a way so that there is little public information available, namely "over the counter" (OTC) as a contract between two counter parties (OTC markets).

Value of the non-transparent OTC derivative markets, in notional amounts outstanding

Major types of OTC derivative markets		Gross notional amounts outstanding, December 2008	Notional amount outstanding in net terms (taking into account that the same derivative is being sold again)
1. Credit default swaps	$ 29 trillion on 22 May 2009 was $ 62.2 trillion at end of 2007	$ 38.6 trillion	$ 2.5 trillion on 22 May 2009
2. Interest rate derivatives, of which:	Total	$ 418.6 trillion	
	Interest rate swaps	*$ 328.1 trillion*	
	Interest rate options	*$ 51.3 trillion*	
	Forward rate contracts	*$ 39.3 trillion*	
3. Equity derivatives	was $ 10 trillion in June 2008	$ 6.5 trillion	
4. Commodity derivatives	Includes: gas trading, base metals trading, power trading, crude oil trading, agriculture trading and emissions trading	$ 4.4 trillion	
5. Foreign exchange derivatives		$ 49.7 trillion	
TOTAL		**$ 517.8 trillion**	**(might be just one third of $ 517 trillion)**

Source: based on data from : EC, Commission staff working document accompanying the Commission communication - Ensuring efficient, safe and sound derivatives markets, 7 July 2009, chart 4 - OTC derivative market segments.

During the financial crisis, the derivative markets and especially the OTC derivative markets, have shown that can undermine financial stability, especially when the market conditions change rapidly, because of their characteristics[36]:

- the private nature of contracting with limited public information (also not available for supervisors)
- the unexpected impact of swift movements in the valuations of the underlying

[36] EC, Commission staff working document accompanying the Commission communication - Ensuring efficient, safe and sound derivatives markets, 7 July 2009.

- the difficulties of understanding the nature and level of risks, which has made them to be among the "toxic" financial products
- the difficulties to know to where and whom the risks have been transferred to
- the high level of concentration of participants
- the complex web of mutual dependence whereby a few major financial industry actors participate in most segments of derivative markets as well as other financial markets with complex instruments (e.g. securitized financial products) are highly interconnected with large spill-over risks,
- the impact of prices in derivatives markets on other financial markets.

What the EC says about what the main problems are that it wants to deal with

Lack of transparency: Because many derivatives have been traded "over the counter" (OTC), derivative traders and other market participants as well as authorities and supervisors did not know which derivative trading was taken place, how a complex web of mutual dependence between market operators was being created, how to disentangle this interdependent market and how to manage the markets in case of defaults and non-payment by major derivative market participants. The crisis and the fall of Bear Stearns and Lehman Brothers was caused by defaults on sub-prime mortgages and their exposure through collateralised debt obligations (CDOs) while AIG was exposed by CDS that the latter had sold on those CDOs. This resulted in a mistrust among the market participants about each other's capacity to pay, a lack of lending to those who participated in derivative trading (credit crunch) and lack of money for the derivative markets.

Lack of adequate risk management: to ensure payments based on derivative obligations take place when speculation/bets would go wrong in times of financial turmoil. The OTC markets rely too much on individual, private, contracts between dealer and clients based on the "honourable obligations" of both parties to pay.

The EC's proposals and initiatives

Kind of initiative	Date of issue	Consultation	Content	Decision-making	Website
Communication and staff working document from the EC on "Ensuring efficient, safe and sound derivatives markets"	7 July 2009	separate document also published on 7 July	In addition to existing initiatives, promote : central counter-party clearing, standardisation; automatic processing, central data repositories, more publicly available information	Proposals for measures to be published after consultation on communication is over	http://ec.europa.eu/internal_market/financial markets/docs/derivatives/communication_en.pdf http://ec.europa.eu/internal_market/financial markets/docs/derivatives/report_en.pdf

Consultation document on possible initiatives to enhance the resilience of the OTC derivatives markets	7 July 2009	End of consultation period 31 August 2009	Promote: CCP clearing; standardisation; better bilateral collateral management, central data repositories, more public trading venues, and other transparency measures		http://ec.europa.eu/internal_market/consultations/docs/2009/derivatives/derivatives_consultation.pdf
a high-level consultation conference entitled "Derivatives in crisis: Safeguarding financial stability"	Announced on 7 July 2009	Date of consultation conference: on 25 September 2009, Brussels			http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm#conference
Policy orientations for over-the-counter (OTC) derivatives in general	Expected to be published by EC by the end of October 2009				http://ec.europa.eu/internal_market/whatsnew_en.htm
Legislative proposals and review of existing regulatory framework (if considered necessary)	Expected before end 2009			ECOFIN & EP (econ)	http://ec.europa.eu/internal_market/whatsnew_en.htm

On 7 July 2009, the EC has issued a Communication with proposals on how to make derivative trading more safe, efficient and sound. The Communication is accompanied by an EC Staff Working document, which explains the operation of the derivative markets and some of the risks. The EC has at the same time, the EC has issued a consultation document in which the EC is seeking the answer to particular questions on how the derivative markets can be made more transparent and less risky. The EC has not made a particular proposal for a directive directly dealing with derivatives nor has it concluded yet whether it will make legislative proposals for introducing new regulations.

Other institutions dealing with the matter which can influence the EU initiatives: CESR[37], the ESCB (European System of Central Banks), the Basel Committee on Banking Supervision[38], G-20[39], US, IOSCO, e.a.

Main elements of the EC communication

The EC proposes "to safeguard financial stability"[40] by dealing with (1) the lack of transparency for supervisors and derivative market users, and (2) the risks of non-payment by the "counter party" of the derivative contract, by:

- **Promoting (not obliging) the use of Central Counter-party Clearing (CCP clearing)** in order to limit the counter party risks of OTC trading (but without forbidding OTC trading). Through CCP clearing, an entity interposes itself between the counterparties to the derivative traded. This central counter-party (CCP, a company) becomes the buyer to every seller and the seller to every buyer of a derivative contract, thus taking over the payment obligations. By clearing, the CCP verifies the calculations and the capacity of the counter parties to fulfil their obligations.[41] The EC wants to diminish but not abolish the dominant 'bilateral clearing' whereby the parties agree among themselves how to assess the value of the contract and deal with disputes and non-payment. In order to promote CCP clearing, the EC is considering whether a change rules would make CCP clearing less expensive (e.g. by diminishing capital requirements) and better supervised in a common EU way. The EC favours more than 1 CCP clearing entity to avoid one point of failure, and to promote competition.
- **Voluntary non-legal agreement with the credit default swaps (CDS) dealers**: As a result of the above mentioned promotion policy, ten major CDS dealers agreed that they would start to clear all "eligible" CDS through one or more central counterparties (CCPs) established and regulated in the European Union, by 31 July 2009. Two private CCPs were ready and approved by 31 July 2009 and a third is expected to be operational by the end of 2009. Through the International Swaps and Derivatives Association (ISDA), dealers have developed the standards necessary to allow central clearing for European CDS. The EC will promote that the authorization of CCPs across EU jurisdictions will be more easy (single approvement process).
- Encouraging the **standardisation of more derivative contracts that are OTC traded**. Without standardisation and automation, the other tools and policy options that the EC proposes can hardly work. For instance, standardisation allows more automatic (electronic) processing of the derivative contracts so that they can be handled by CCP clearing. The EC does not propose to standardise all aspects of derivative contracts, for instance not all the parameters such as the payment arrangements.
- Encouraging **automatic processing of derivative contracts**. The EC argues that this also helps to increase efficiency and reduce operational risks by e.g. electronic affirmation and

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37 E.g. The CESR has recently mandated a Task Force to analyze the possibility to both collect and exchange reports in some OTC derivatives (e.g. options, warrants, contract for difference and CDS) with the objective to help detect cases of market abuse

38 "is currently reviewing the treatment of counterparty credit risk" nl zero-risk weighting capital treatment for certain derivative contracts (if they fulfill certain conditions e.g. use CCP that fulfill certain conditions)

39 The annex of the 2 April G-20 declaration stated that they "promoted the standardisation and resilience of credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision." It also called on the industry to develop an action plan on standardisation by autumn 2009. The follow up of the 2 April declaration means to ensure global consistency and deal with regulatory arbitrage.

40 EC, Consultation document - Possible initiatives to enhance the resilience of OTC derivatives markets, 3 July 2009, p. 1.

41 In jargon: "is the process by which obligations arising from a financial security are managed over the lifetime of the contract"

confirmation services, automation of payments and collateral management processes. Where automation does not take place, the EC proposed to strengthen the bilateral collateral management for non-CCP eligible contracts.

- Considering the usefulness of **central data repositories** where information about all derivative trading (not only those CCP cleared) should be gathered, e.g. the outstanding obligations ("positions"), and to which supervisors would have full access. The EC intends to take action after the Committee of European Securities Regulators (CESR) has studied the usefulness of such a facility.
- Promoting trading of derivatives on facilities and regulated **markets with publicly available information** about prices and other derivative trade related information (number of transactions, what open obligations/positions).
- The EC also refers to its other financial reform initiative and proposals, as discussed in this document, which should deal with the risks of non-payment by the "counter party" of the derivative contract, and wrong valuation, namely:
- The Capital Requirement Directive: more **capital reserves** for (re-) securitisation on which some derivatives are based should make derivatives less risky. Better regulation and supervision should avoid short term risk taking behaviour by the financial industry which is also involved in derivative markets.
- The credit rating agency (CRA) directive should result in **better valuation methods** and better assessment by companies of the value and risks of financial instruments such as derivatives and their underlying.
- Proposals for a Directive to **regulate on Hedge Funds and other alternative investment fund managers (AIFM).**
- The creation of the European Systemic Risk Board (see below about the new supervisory structure) which **should allow better supervision** but only through identifying excessive risks building up in the financial system and raising warnings in order to avoid the excessive risks.

Main elements of the EC staff working document accompanying the Commission communication ("Ensuring efficient, safe and sound derivatives markets". SEC(2009) 905 final)

In order to explain its recommendations in its communication on how to deal with derivatives, the EC staff working document has analysed:

- The diverse types and different forms of derivatives which are mostly traded in non-transparent ways, namely ca. 85% of the derivative market in terms of notional amounts is traded OTC (see above: Table on Value of the non-transparent OTC derivative markets, and see also Annex on terminology)
- How each of the these diverse derivative markets function and how transparent they are, for instance related to:
  - How much derivatives are OTC traded and how much is CCP cleared;
  - How concentrated the dealers are (and how interconnected which is problematic once one defaults)

- Who manages the derivative contracts and how are they managed (e.g. confirming the contracts, payouts structures)
- How the rights and obligations based on the contracts are being valued and managed, and how prices are formed
- What risks are visible and what effective risk management systems are in place, for instance ensuring adequate collateral is in place to be used in case of default
- In how far the number of derivatives are disproportionate in respect to the financial instruments or assets on which they are based.

According to the EC, the most non- transparent (OTC trading) are interest rate derivatives, credit default swaps and foreign exchange derivatives. The EC considers the credit default swaps being one of the most able to destabilize the financial system.[42]

The EC staff working document concluded that supervisors and market participants have no means to gather enough information about how much derivatives with how many risks and obligations for which traders are in the market, and that wrong valuation systems, too little consideration of a potential financial crisis, and too much concentration and interconnectedness among the dealers and users caused the crisis.

Main elements of the consultation document

The EC addresses it questions for the public consultation, via the website, particularly to the financial industry on how it could mitigate some instability risks within the existing market structure, through market incentives but without too much undermining the flexibility of the derivative markets nor putting obligations as outline above, in order to:

- move clearing of standardised OTC derivatives to CCPs;
- promote further standardisation;
- strengthen the bilateral collateral management for non-CCP eligible contracts
- enhance the use of central data repositories;
- move (part or all of) trading to public trading venues;
- increase transparency of prices, transactions and positions.

Some comments, criticisms, and alternative proposals

About the EC's approach:

- The EC fails to fully analyse what the usefulness of these derivative markets are for the whole economy and for society (e.g. social and environmental aspects), who is benefiting (only the rich and well informed?) and who is loosing, and whether it is useful to continue derivative markets and just make them more safe and efficient as the EC proposes. The EC's starting point is that derivatives are beneficial for the economy because they can hedge i.e. protect

[42] EC, Commission staff working document accompanying the Commission communication - Ensuring efficient, safe and sound derivatives markets, 7 July 2009, executive summary : since it has a "discontinuous pay-out structure, concentrated dealer market structure, difficulty of valuing the rights and obligations contained in the contract, lack of solid risk management measures and disproportionate dimension of the derivative market with respect to the underlying market. Most other OTC derivatives appear less risky".

against risks taken by entrepreneurs, producers and traders. It recognizes that derivatives have been used to hold less capital reserves against risks for instance by lenders (e.g banks through credit default swaps). However, the EC fully understates the pure speculative aspects of many derivatives markets. The EC has not analysed in how far speculation drives the market and whether derivative innovations, and speculators using them, have any value for society. Many critics have stated that many pure speculative derivatives create no added value for the economy but have enormous macroeconomic and stability consequences in times of crisis. The EC proposals fail to limit speculation through derivatives. For instance, index derivatives[43] and other speculative products such as "naked" credit default swaps should be forbidden as there is absolutely no public interest served with those activities.

- The EC's analysis fails to look at what the risks are for society **and societal issues such as food prices, house prices, impact of foreign exchange speculation on developing countries'** economies, etc. For instance regarding **food commodity derivatives**, the high increase of very speculative participants in commodity derivative markets over the last years has changed the nature of this derivative trading market and has limited its function of hedging (to ensure stable) food commodity prices for producers and consumers.[44] Even the U.S. supervisory authority states that commodity derivatives have created price distortions, or possibly even a speculative bubble. However, the EC has taken no initiative to specifically stop this kind of speculation which has direct consequences for access to food by the world poorest[45]. Prices are indeed unstable amongst others also because of unstable costs of inputs (partly due to speculation in energy markets) and reduced access to credit (partly due to the financial crisis), but these price instabilities should not be exploited by speculators. At least, all those who trade in commodities on the spot or derivative market would need to be registered. Only those traders who enable hedging and are directly linked with the real commodity trade (thus not hedge funds or other speculators), know the market and are subject to stock exchange supervision should be permitted. For a long term solution, other commodity price insurance and price stability mechanisms should be developed to replace current hedging on derivative markets.
- The focus of the EC proposals is on market solutions through transparency and capital requirements, **market incentives and self-regulation**, with a possibility of intervention by supervisors, instead of opting directly for prevention. Many of these approaches were adopted (including through international standards) before and after the Asian crisis but have failed to prevent a financial crisis. The EC consultation and proposals are too much narrowly focused on mechanisms within the existing market structures, solutions proposed by the derivative users and traders themselves, and avoidance of loss of flexibility and additional costs for so-called safe derivative users.
- The EC fails to analyse the risks of **carbon derivatives** which are now seen as a potential financial bubble. Carbon derivatives have pollution permits as the underlying. The pollution permits are part of CO2 emission trading system which is based on the principle that polluting companies buy carbon credits from those who are polluting less somewhere in the world and have therefore carbon credits or pollution permits to sell. Financial engineers already developed complex financial products to speculate, such as derivatives, based on this carbon

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43 P. Wahl, Food speculation - The main factor of the price bubble in 2008. WEED, Berlin, [2008], p. 15 http://www2.weed-online.org/uploads/weed_food_speculation.pdf

44 Testimony of Michael W. Masters before the Committee on Homeland Security and Governmental Affairs, United State Senate, 2 June 2008.

45 P. Wahl, idem.

emission trading while OTC and exchange-traded carbon derivative products have developed and grown over the last years.

Comments within the narrow approach of the EC's proposals:

- The EC's proposals fail to fully achieve the principles of its narrow approach to avoid instability to the financial system:
  - full transparency is not reached as its proposals would not cover all derivative trading ;
  - the EC admits that CCP clearing does not eliminate the risk that the counter party of a derivative contract cannot pay while this is a very important issue to avoid financial instability;
  - the EC admits that promoting CCP clearing needs a lot of prerequisites
  - the EC recognizes that "standardisation requires costly investments and, therefore, additional measures might be considered necessary to provide the adequate incentives to promote it, in the spirit of G20 declaration".
  - the EC admits that some of its proposals might not be feasible or that there is no guarantee that they can or will be implemented. However, the EC gives no guarantee that it will submit all necessary legislative proposals to ensure the full application of its limited current proposals since it is very willing to take into account the wishes of the financial industry.

  In contrast, the EC could adopt proposals that a European Central Counter-party clearing mechanism should be regulated, supervised and obligatory for all OTC trading, that bilateral OTC trading is prohibited and that all derivative financial products should be sufficiently standardized and run on transparent, regulated and supervised exchange markets[46].

- **The EC tries to combine two conflicting interests**: (1) the desire for flexibility which can only done so far through non-transparent and risky instruments and (2) "societal preference" for transparent and standardized trading places where information is publicly available and easy to understand. Rather, the EC should choose for the full transparency option and the "societal preference" since the non-transparent financial industry has shown to be unable to prevent itself from provoking a huge financial crisis.

- The incentives proposed to increase the use of more transparent market instruments (e.g. CCP clearing) suggest that less stringent demands would be made for putting aside capital reserves in case of default, which seems to go in the opposite direction of requiring more capital reserves for risky instruments even if there are market instruments that seem to be able to avoid too much risks (CCP) (see "regulatory capital incentives – zero-risk weighting")

- The EC does not elaborate on the increased capacities needed by the supervisory authorities once transparency is improved as it proposes (e.g. resources, technical knowledge, etc.).

[46] J. Stiglitz, 2008, http://www0.gsb.columbia.edu/ipd/pub/Financial.Market.Reform.Meeting.Minutes.final.show.pdf

3 Taxation: What is changing for tax havens and tax evasion?

Because of the financial crisis, tax havens and tax evasion have been put on the political agenda because tax havens were hosting some of the complex financial products and operators which caused severe financial instability but had remained invisible to everybody. In addition, enormous amounts of tax money is being needed to deal with the financial and economic crisis, and pay for the rescue packages of banks and insurance companies which had become too big to fail. Therefore, there is more attention to those earning lots of money (including those destabilizing the financial system such as Hedge Funds) are not paying taxes. Indeed, after a period in which the financial sector's huge profits had been transferred to the private sector through excessive remuneration and bonuses, profits on equities and dividends ('privatizing the profits'), taxpayer's money had to be used to stop the worst societal and economic consequences of the financial sector's failures ('socializing the losses').

Now that the enormous bill (around $ 4 trillion) is becoming clear, there is a discussion among and within the EU member states how much money of the governmental budgets can be pored into the financial sector and into the ailing economy while infringing the limits on budget deficits set by the European Stability and Growth Pact. Also, a discussion about more taxation, for instance of transactions within the financial sector, is starting.

3.1 Review of the Savings Taxation Directive

Background

Since July 2005[47], the EU Savings Tax Directive (STD) has been trying to tackle tax evasion by promoting automatic exchange of information between tax authorities. The STD provides that information about of interest payments (on bank deposits) paid by a paying agent[48] (usually banks) to a person residing in another EU member state is automatically sent to that other member state every year. This should enable Member States to apply their own taxation rules to interest payments that their residents have received from paying agents in other Member States. This directive currently applies to all EU member states, except three member states (Belgium, Luxembourg and Austria). The latter have been temporarily granted the right not to apply the exchange of information requirement, but are instead obliged to levy a withholding tax on the interest income received by taxpayers resident in other EU Member States. The same or equivalent provisions of the Directive (exchange of information or withhold tax) have also been applied in 5 European third countries (Switzerland, Liechtenstein, Monaco, Andorra and San Marino) and in 10 dependent or associated territories of the United Kingdom and the Netherlands (Anguilla, Aruba, the British Virgin Islands, the

[47] It came into effect on July 1st, 2005 but was adopted in 2003.

[48] Under the directive, the concept of "paying agents" refer to every person who pays interest to individuals in the framework of a professional activity such as a financial institution, a bank or an independent asset manager. Ordinarily, they are obliged to report information on the identity of the owner of the interest to their tax authorities, who pass the information to the member State of residence of the beneficial owner, at the time when the interest payment is made to that beneficial owner (paying agents established in states or territories which apply the withholding tax are obliged to withhold a tax instead of communicating information). These agents could be defined as the normal paying agents "upon distribution" within the framework of the directive; source: http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/technical-questions.pdf

Cayman Islands, Guernsey, the Isle of Man, Jersey, Montserrat, the Netherlands Antilles as well as the Turks and Caicos Islands) through the implementation of bilateral agreements. Because this Directive was very limited because it did not apply to financial income beyond interest payments, and because it could be easily circumvented by using legal entities, e.g. by creating a trust or foundation, a review of the directive is under way.

Decision making on amending Directive 2003/48/EC on taxation of savings income in the form of interest payments

Kind of initiative	Date of issue	Consultation	Content	Decision-making	Website	Application
DG Taxation and Customs Union publication	*22 July 2009*		*Taxation Paper No 18: "Tax Co-ordination in Europe: Assessing the First Years of the EU-Savings Taxation Directive"*	n.a.	http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_18.pdf	
Proposal to the Council to amend Directive 2003/48/EC	*13 November 2008*		limiting tax evasion from innovative financial vehicles and constructions, and ensuring all investment funds and schemes are taxed	By the Council only, scheduled for ECOFIN meeting of 2 December 2009	http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/savings_directive_review/index_en.htm.	

The European Parliament has no co-decision making power on tax issues. The Economic and Monetary Committee of the EP has discussed the proposals and given its opinion on the proposal its report of 13 May 2009.

The Council, which has the decision-making power, is expected to come to a political agreement on final the act during Council meeting of Ministers of Finance of 2 December 2009.[49]

Main elements of the revision of the Savings' Tax Directive

The EC's mainly proposes to limit tax evasion by extending the application of the Directive (exchange of information or withhold tax) to[50:]

[49] http://www.europarl.europa.eu/oeil/file.jsp?id=5714632

- Income from **innovative financial vehicles** other than classical savings accounts such as income from certain securities[51] and certain life insurance contracts
- **Intermediate legal person or structures, such as foundations and trusts, established within the EU**: they will have to exchange information or withhold tax themselves, when they receive any interest payment from any economic operator (e.g. bank) that is established anywhere, even if they are not taxed under direct taxation rule in their Member State of residence/establishment.
- Interest payments made **to intermediate legal persons or structures established outside the EU** but whose beneficial owner is known to be person residing in the EU: the agents (e.g. banks) based in the EU which pay such interests will have to exchange information or withhold tax.
- In addition, the EC aims at a level playing field between all investment funds and schemes by ensuring that they are subject to effective taxation.

Some comments, criticisms and alternative proposals

- While the proposed directive would apply to more forms of savings than interests on bank accounts and will cover structures that were used to evade taxation on personal savings, the new directive will not cover all types of incomes from investments such as dividends, capital gains, 'out payments' from genuine life insurance contracts and pension schemes, etc.
- The proposed Directive does not put an end to the option of withholding taxes rather than automatically exchange information. That option is currently applied Belgium[52,] Luxemburg and Austria within the EU as well as most of non EU countries cooperating with the STD. However, the EC (DG Taxation and Customs) made proposals for new directives which would prohibit the use of bank secrecy as a reason not to cooperate with another EU Member State when requesting assistance in case of tax fraud (see below: "good governance" in tax area).
- The list of jurisdictions in which intermediate structures are based and to which the TSD applies[53] is incomplete and does not include jurisdictions that are used by tax evaders such as Dubai, New Zealand, Ghana, or certain states of the USA (in particular, Delaware, Nevada, and Wyoming) should. Indeed, they are currently marketing themselves on the basis of being outside the STD scheme and so available for use by tax evaders[54].
- The Annexes of the STD omits to list a number of structures (such as trusts or foundations) established in several EU countries that should subject to the information disclosure or tax deduction requirements. According to R. Murphy, "*the countries for which a reference to trusts is omitted at present are Germany, Malta, the United Kingdom and Ireland*" [55].This implies that

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[50] EC, Taxation of savings: The European Commission proposes changes to eliminate tax evasion, IP/081697, 13 November 2008, http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1697

[51] Namely securities which are equivalent to debt claims (of which the capital is protected and the return on investment is pre-defined)

[52] In this respect, it is worth noting that Belgium recently announced its intention "to adopt the automatic data exchange system and amend the relevant agreements on this", in DEUTSCHE BANK RESEARCH, June 22, 2009, « EU Savings Taxation Directive : One piece in the puzzle of cross-border tax policy", http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000243300.pdf

[53] See Annex I of the Directive.

[54] For a complete list of such jurisdictions, see R. Murphy, "Plugging the gaps: reform of the EU savings tax directive", Tax Justice Network, 2 December 2008, http://www.taxresearch.org.uk/Documents/Plugginggaps.pdf

[55] For more details, see R. Murphy, op. cit.

those who wish to evade tax have currently the opportunity to create trust structures in these locations[56] that can receive gross interest, without being covered by the provisions of the proposed STD. Also the lists of entities and legal arrangements that are not subject to taxation on their income[57] are incomplete, leaving a grey area whether the STD applies to certain legal arrangements in and outside the EU.

- In order to eliminate all tax fraud by individuals, at least automatic information exchange is required in all cases. Also, all sources of cross-border payments and investment incomes should be taxed – including dividends, capital gains, payments from pension insurance systems, etc. In addition, the list of the legal entities covered by the STD should extended and include "an onus of proof resting on a jurisdiction if they wish to have an entity of the type named excluded from the list for their jurisdiction".[58] Also, a mechanism should be included for adding newly identified generic entities with potential applicability to all jurisdictions.[59]
- This directive does not deal with several tax avoidance and tax evasion strategies by companies. Nor does the directive deal with the problem of very low taxes on some incomes from companies and the ongoing competition among EU member state countries to set taxation on company incomes (profits, royalties, internal interest payments) low as a strategy to attract foreign companies and foreign investment. There is a non-binding EU Code of Conduct for Business Taxation in which EU member states commit themselves not to apply tax measures[60] that might harm other member states.

3.2 EC proposes actions on "good governance" in the tax area

Background

While decision-making at EU level on tax is more limited than on financial services and financial market issues, the EC (DG Taxation and Customs) has already developed some elements of "good governance" in the tax area. In order to reinforce the G20 conclusions (April 2, 2009), "to take action against non-cooperative jurisdictions, including tax havens" and avoid that EU member states act alone in an un-coordinated way and without cooperation among themselves, the EC has made proposals on the approach EU member states and the EU should take to protect their tax revenues.

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[56] Although Germany has no trust law, its residents are allowed to administer foreign law trusts.

[57] Also known as "tax transparent" entities: transparent A fund is tax transparent when the fund itself is not subject to taxation and the investment in the investee company is treated as if it were a direct investment for the initial investor in the fund (the limited partner), who is then taxed when the investment fund distributes its profit, see http://ec.europa.eu/enterprise/policies/finance/glossary/index_en.htm

[58] For an exhaustive list of entities that should be listed as being automatically deemed "tax transparent" for STD purposes in every jurisdiction referred to in Annex I, see R. Murphy, op. cit.

[59] Ibidem.

[60] The criteria for identifying potentially harmful measures include http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm):

- an effective level of taxation which is significantly lower than the general level of taxation in the country concerned;
- tax benefits reserved for non-residents;
- tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
- granting of tax advantages even in the absence of any real economic activity;
- the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD;
- lack of transparency.

Decision making process

Kind of initiative	Date of issue	Consultation	Content	Decision-making	Website	Application
DG Taxation and Customs, adopted two proposals for new Directives	2 February 2009		Measures to improve cooperation between Member States' tax authorities to assess and recover taxes (incl. not invoking bank secrecy)		http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/201&format=HTML&aged=0&language=en&guiLanguage=en.	
DG Taxation and Customs, publication	8 April 2009		Taxation Paper No 16 - International Taxation and Multinational Firm Location Decisions		http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_16_en.pdf	
Communication from DG Taxation and Customs	28 April 2009		Identification of actions to improve cooperation among EU Member States as well as with third countries to tackle tax evasion		http://ec.europa.eu/taxation_customs/common/archive/news/index_en.htm	

Main elements of the EC communication on good governance in the tax area

The Communication covers different other communications relating to improving existing initiatives or decisions or introducing new initiatives. This relates two different areas of cooperation and coordination among the EU member states to improve fighting tax evasion within the EU and by EU nationals around the world.

1. Improving good governance within the EU by swift adoption by the EU member states of the following proposals already made by DG Taxation and Customs relating to:

- Effective and better cooperation between the administrations of different EU Member State to recover tax, in particular, by:
  - prohibiting Member States in future from invoking bank secrecy laws as a justification for not assisting the tax authorities of other Member States ;
  - obliging EU Member States to provide the same level of cooperation to each other as they have agreed to with any third country.

- Improving the functioning of the Savings Tax Directive (see above) by extending the scope of the Directive to intermediate tax-exempted structures (trust, foundations...) and to income equivalent to interest obtained through investments in some innovative financial products.

- Continued elimination by Member States of harmful business tax measures under the Code of Conduct for Business Taxation[61].

2. Improving tools for good governance in the relations with third countries by:

- including good governance in tax principles in relevant EU-level agreements with third countries;
- using development cooperation incentives to encourage third countries to improve good governance in tax; in addition, reallocate funds to developing countries that are implementing satisfactorily their commitments, and, conversely, consider a cancellation of funds earmarked for those countries that did not implement their commitments;
- a coordinated and coherent approach EU Member States in the promotion of good governance principles towards third countries, including coordinated action against jurisdictions that refuse to apply good governance principles e.g. regarding counter-measures towards non cooperative jurisdictions in the tax area[62];
- promoting more cooperation with third countries in the framework of the Savings Tax Directive;
- concluding specific agreements at EU level in the tax area containing provisions on transparency and exchange of information for tax with certain jurisdictions;
- better coherence between Member States' own bilateral tax policies towards third countries and the principles of good governance in the tax area.

Some criticisms and comments

- This proposal does not deal with the structures used by (investment) banks, hedge funds and private equity to be based in tax havens not only not to be taxed but also to remain intransparent regarding their activities, risks and liabilities. Such a proposal would need adoption by unanimity by the EU member states.
- While this is a good attempt to coordinate and speed up actions on tax fraud issues which are partly outside EU decision making processes of the EC and the EP, the proposal still the minimum of what would be needed to fully tackle tax evasion in the EC and around the world.
- The fact that development cooperation aid (ODA) might be used as a leverage or even sanction on developing countries to ensure that they are not used as tax havens is an dangerous approach if first tax evasion mechanisms that still exist in the EC and other OECD countries (who do not receive ODA) are not tackled (would otherwise be double standards), and if EU member states take no additional measures to ensure that multinationals based in the EU but operating in developing countries cannot evade or avoid taxes in developing countries.
- The proposal does still very little about harmful tax competition especially related to taxing companies among EU member states and among countries in the world.

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[61] See footnote above on the criteria for identifying potentially harmful measures.

[62] The OECD Secretariat has already suggested a list of measures: these would need to be examined together with the Member States

3.3 No formal proposal yet to introduce a Financial Transaction Tax

Background

While there is a huge public pressure, and some political action (see below), to stop the high bonuses, there is little discussion on how there could be more burden sharing by the financial sector and more taxation could be applied within the financial sector. Such financial sector tax money could for instance be used during a financial crisis or to compensate the budget deficit caused by the financial and economic rescue packages. Civil society organisations have proposed to introduce a financial transaction tax on all kinds of financial transfers, including currency transactions. This would include a (small) tax on foreign exchange transactions to deter short-term currency speculation, as proposed by James Tobin, the Nobel prize-winning American economist, or amended by Prof. Spahn.

Political decision-making

No proposal on a financial transaction act has been officially and formally made within the EU and EU member states since the financial crisis (Belgium already had a law that would introduce the tax if other countries also did so and France has promoted it to finance developing countries).

However, discussions about a financial transaction tax were raised after Lord Turner, the chairman of the Financial Services Authority which is the UK financial watchdog, proposed in an interview the idea of a new global taxes on transactions and referred to the Tobin Tax.[63] He said this would be a better way to diminish high bonuses paid by a “swollen” banking sector as the profits of the financial industry would go down. He was immediately attacked by the London City financial industry and its proponents, among others also because Turner said that the regulator should be “ very, very wary” of seeing London’s competitiveness as a main aim.[64]

[63] G. Parker, Art. “London watchdog chief backs global tax” ,in Financial Times, 27 August 2009.
[64] P. Jenkins, G. Parker, Art. “ FSA chief suffers backlash on ‘Tobin tax’ idea”, in Financial Times, 28 August 2009.

4 Will banks be at the service of a sustainable society?

Many critics of the financial system have indicated that an underlying cause of the financial crisis is to be found in the fact that the financial industry was mainly serving the rich to make more profits out of capital, as well as serving big companies and projects which could have high financial returns while having damaging social and environmental effects. In other words, the financial system has not been at the service of those who need financial services and money the most, nor at the service of activities (economic or other) that lead to social advancement and environmental protection as well as other aspects of "sustainable development". The question is whether the financial reforms that are being discussed and introduced will change the financial system and be more oriented to meet the needs, especially the urgent social and environmental ones, of societies around the world.

Below are some financial reform initiatives at the EU level which relate, or should relate, to more sustainability and orientation of servicing average citizens.

4.1 Consultation on responsible lending and borrowing in the EU

Background

The sub-prime mortgage crisis in the US has revealed that loans were sold without consumers fully knowing the risks and being able to repay the payment obligations. Because these risky and irresponsible lending practices resulted in huge payment defaults, while these loans were the basis for many widespread speculative financial products (see: credit default swaps, securitisation), they were able to trigger the current financial crisis. The EC wants to ensure that such practices are not taking place in the EU and to show that it is taking action to protect consumers.

Decision making process

Kind of initiative	Date of issue	Consultation	Content	Decision-making	Website	Application
Public consultation	15 June 2009	Ends 31 August 2009	Protecting consumers regarding: advertising and marketing of credit products; pre-contractual information; assessments of product suitability and borrower creditworthiness; advice standards; a framework for credit intermediaries		http://ec.europa.eu/internal_market/consultations/docs/2009/responsible_lending/consultation_en.pdf	

Public hearing		On 3 September 2009			http://europa.eu/rapid/pressReleasesAction.do?reference=MEX/09/0831&format=HTML&aged=0&language=EN&guiLanguage=en	

Main elements of the consultation

The Commission wishes to stimulate lending and borrowing in a more responsible manner in order to prevent it from damaging consumers, lenders, the financial system and the economy at large.

Responsible lending is defined as selling of credit products that are appropriate for consumers' needs and are tailored to their ability to repay. Responsible borrowing is taking place when consumers are provided with relevant, complete and accurate information on their financial conditions. Responsible lending and borrowing are seen as vital components to ensuring a stable and effective credit market[65] and should deal with:

- The advertising and marketing of credit products;
- the pre-contractual information provided;
- ways to assess product suitability and borrower creditworthiness;
- advice standards;
- framework for credit intermediaries (disclosure, registration, licensing and supervision)

Some comments, criticisms and alternative proposals

- The proposals for responsible lending and borrowing do not cover issues that related to areas of sustainable development such as ensuring that the loan does not lead to activities which are socially or environmentally harmful. However, there are already many initiatives that have developed criteria for responsible lending and corporate responsibility of credit institutions on which the EC could rely on, e.g. Equator Principles, GRI reporting in the financial sector, "Eerlijke bankwijzer" (Fair Bank Guide), etc.
- While there is some recognition that the current economic crisis provides an opportunity to reform the economy towards more sustainable patterns, with focus on dealing with climate change, non of the financial reform initiatives by the EU include measures to ensure better financing mechanisms towards sustainable activities. By failing to incorporate sustainable development and climate change issues into the EC proposal on responsible lending and borrowing, the EC misses an important opportunity to include these issues in the financial reforms in an easy way.

[65] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/922&format=HTML&aged=0&language=EN&guiLanguage=en

4.2 Deposit Guarantee Schemes (DGS) Directive

Background and decisions already taken

The Deposit Guarantee Schemes Directive (first agreed in 1994) obliges all Member States to set up compensation schemes for depositors. Deposit Guarantee Schemes ensure a repayment of individual (and sometimes small companies') savings up to a certain amount in case a bank goes bankrupt. It helps to prevent a run on a bank in case of periods of financial turmoil.

The DGS directive has been amended at the end of 2008 to prevent Member States from competing with each other during the credit crunch and financial crisis by raising the level of guarantee schemes in order to attract foreign deposits. The new directive requires all credit institutions authorised in the EU be a member of a DGS. Deposits based in branches in another Member State are covered by the guarantee scheme of the home Member State where the headquarters are based. However, branches of credit institutions from other Member States have the option to joining DGS voluntarily in the host Member State to supplement the coverage afforded by the home Member State. This principle of topping-up will more-or-less disappear by 31 December 2010, when all EU Member States have to ensure that the deposit guarantee coverage of all the deposits of each depositor at one particular bank shall be set at EUR 100,000 according to the new directive. Currently Member States have to ensure a level of at least EUR 50,000 in the event of deposits being unavailable.

The fact that the member states have to pay for the deposits in case of bank failures, has made member states reluctant to give all supervision in the hands of supervisory authorities at the EU level who would not have to be responsible for the deposit guarantee payments in case of default due to supervisory failures. However, the fact that some member states might be too small to pay for all deposit guarantees of the branches of their banks operating across the EU, has raised the discussion to introduce an EU wide deposit guarantee system.

Decision-making process on the Directive on Deposit Guarantee Schemes

Kind of initiative	Date of issue	Consultation	Content	Decision-making	Website
Consultation on the review of the existing Directive	27 May 2009	End of consultation period: 27 July 2009	harmonisation of funding mechanisms and scope of deposit guarantee schemes, discussion points about an EU wide deposit guarantee schemes		http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm
Legislative proposals and review of existing regulatory framework (if considered necessary)	Expected before the end of 2009			ECOFIN & EP (Econ)	http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm

Main elements of the review of the DGS directive

The deposit guarantee system will be reviewed by the end of 2009 on several elements, including:

- the harmonisation of the (risk-based) mechanisms for funding the deposit guarantee systems;
- the scope of deposit-guarantee schemes;
- the benefits and costs of a possible introduction of a Community deposit guarantee system.

5 Reforms of the structure to supervise the financial sector operating in the EU

5.1 Communication on reforms for European financial supervision

Background and some decisions taken

While the EU constitution generated a free market for financial services and free flow of capital, many competences for supervision of the financial services industry operating across EU borders remained at national level of the member states.[66] As a result, the European structure of financial supervision has been fragmented with more than 80 national and sectoral supervisors, and structures of these supervisors at EU level with mainly advisory and implementation functions (so-called Lamfalussy committees[67]). The financial crisis has shown that this structure was clearly inadequate to catch up with the developments of cross-border and cross-sectoral innovative financial products and to oversee risks building up in the overall financial system while risks models showed little problems at the financial firm level. In addition, the lack of cross-border information sharing and cooperation impeded a coordinated response to the financial crisis and regarding rescue measures of cross border financial firms (e.g. Fortis). Also, there is no the burden sharing mechanisms in cases of possible default while financial firms are operating across the EU.

The review of the Capital Requirements Directive that was adopted in May 2009 obliged the creation of colleges of national supervisors of those countries in which the same cross-border financial firm is operating. However, this did not solve the international practice whereby the main supervisory power and work lies with the supervisor of the country in which the headquarters of cross border bank are located, i.e. the "home supervisor". The "host supervisors", especially of small EU member states, are afraid that they had too little say about EU based cross-border financial firms operating in their country and too little power to go against a decision by the home supervisors which they saw as damaging to their country. Also, by lighter supervision and regulation (including light implementation of EU directives) EU countries were competing against each other to attract foreign financial firms (regulatory and supervisory arbitrage).

In order to solve the problem of the lack of EU level supervision of the 30 to 40 EU-based large cross-border and often cross-sector financial players, and to deal with situations of conflicts between supervisors, the EC asked the advice on financial supervision and regulation in the EU to a High Level Group chaired by Jacques de Larosière, which published its report on 25 February 2009.

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[66] See M. Vander Stichele, Financial regulation in the European Union - Mapping EU decision making structures on financial regulation and supervision, December 2008, http://www.eurodad.org/uploadedFiles/Whats_New/Reports/EUMapping_Financial_Regulation_FINAL.pdf

[67] See M. Vander Stichele, idem.

Decision making process

Kind of initiative	Date of issue	Consultation	Content	Decision-making	Website
Communication on European financial supervision	27 May 2009	End of consultation period; 15 July 2009	a new supervisory architecture for all financial services by creation of: a new European Systemic Risk Council (ESRC), and European System of Financial Supervisors (ESFS) composed of European Supervisory Authorities (ESAs)	(was not discussed in EP due to elections)	http://ec.europa.eu/internal_market/finances/committees/index_en.htm
Legislative proposals and review of existing regulatory framework (if considered necessary)	Expected in early autumn 2009			ECOFIN & most likely EP (econ)	http://ec.europa.eu/internal_market/finances/committees/index_en.htm#communication

On 27 May 2009, the European Commission released a communication for public consultation and political discussions at the Council and the European Parliament, in which it proposed a set of reforms about financial supervision in the EU. The EC's proposals are based on the so-called deLarosiere report which included 31 recommendations on a wide range of issues.

On 9 June 2009, the Council agreed with the objectives laid down in the EC Communication and asked the Commission to present all necessary legislative proposals by early autumn 2009 at the latest. Future legislative proposals will have to be agreed through co-decision by the European Parliament and the ECOFIN except if the legal base for such a decision is changed and would only allow the EP to give its advice.

Main elements of the EC proposals in its communication of May 2009

The EC proposes to introduce the following new supervisory bodies:

- European Systemic Risk Council (ESRC) would be a consultative body that assesses risks to the stability of the financial system as a whole ("macro-prudential supervision") rather than per financial firm individually. The ESRC would provide early warning of systemic risks that may be building up and, where necessary, make recommendations for action to deal with these risks. The composition of the steering committee, with Central bankers and the three chairs of the European Supervisory Authorities (ESA: see below), chaired by the European Central Bank, makes it possible to share macro- and micro prudential data.
- European System of Financial Supervisors (ESFS) for the "micro-prudential supervision" of individual cross-border financial institutions, such as banks and insurance firms, and would

combine nationally based supervision of firms with specific tasks at the European level. The ESFS would consist of a network of national financial supervisors brought together in the European Supervisory Authorities (see below). The ESFS should work to harmonize supervisory practices, establish a central European database aggregating all micro-prudential information, work on the realization of a single rulebook of EU standards for supervision of all European financial institutions, and ensure a coordinated response in crisis situations.[68] This network should aim to enhance trust between national supervisors by ensuring, inter alia, that host supervisors have an appropriate say in setting financial stability and investor protection policies and adopting principles of flexibility and subsidiary. It would not have the power to order governments to bail out struggling banks and other bodies which could have huge budgetary consequences which so far would still need to be paid by the home country. [69]

- European Supervisory Authorities (ESA's) are created by the transformation of the existing Lamfalussy Level 3 Committees for the banking (CEBS), securities (CESR) and insurance and occupational pensions sectors (CEIOPS) into better resourced bodies called the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority. The ESA's will get binding decision-making power in case of conflict between national supervisors in a college of supervisors of a particular bank.

Some comments, criticisms and proposals

- The EC proposal lacks the ambition to set up a European financial supervisor that would have a full oversight on all cross-border capital flows and all cross-border and cross-sectoral activities of financial firms that operate in the European Union. If the current EU cross-border financial system is not being restricted, the EC should propose a single European financial supervisor which has a complete oversight of all cross-border and cross-sectoral market activities, or at least has the responsibility for the prudential and financial stability supervision of the 30 to 40 large EU cross-border players which dominate the wholesale activities in the EU and create the major systemic risks in the EU. All new European financial supervisory institutions should have the complete overview of all flows of capital. Some critics point out that for the purpose of stability a choice needs to be made between a free European market of financial services in EU with regulation and supervision fully at EU level, or to only have national (or limited cross-border) financial services based on national keep supervision and regulation.
- The European Systemic Risk Council (ESRC) has only the 'power of its voice'. In good times, its warnings may well be ignored and during a crisis it may have to keep officially silent for fear of sparking panic[70.]
- On a micro-prudential level, the supervisory structure is still primarily based on national supervision. It could still lead to competition for the lowest supervision standards in order to attract or keep financial firms (supervisory arbitrage). The European supervisory authorities (ESA's) would have no mandate to decide on measures which costs money, such as

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[68] K. Lannoo, The road ahead after de Larosiere. Brussels, FEPS, 2009; see also: http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6531396.ece

[69] D. Charter. Art. "Brown signs up to EU financial rulebook - UK agrees to a 'single rulebook' but fends off attempts to give EU power to order governments to bail out struggling banks", in Timesonline , 19 June 2009, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6531396.ece

[70] Art. "Divided by a common market", The Economist, 2 July 2009.

propping up banks with more capital[71]. Only in the exceptional case of disagreement in a college of supervisors, there is European decision-making by CEBS or CEIOPS or their successor ESA bodies.

- One of the reasons why the EC could only propose limited powers to the European System of Financial Supervisors is because the EC failed to include in this proposal to tackle the issue of burden sharing but rather started the discussion by the consultation on deposit guarantee system (see above). ECOFIN has indeed already concluded that a European supervisory structure may not erode the budgetary responsibilities of the Member States. If there is no agreed formula on how to share the burden of the costs to rescue banks or other financial firms and guarantee the deposits of their customers across Europe, the Member States will fall back on national solutions favouring their own financial interests in case of defaults because they are paying the bills. Moreover, there is no European mechanism to let cross-border financial firms go bankrupt in an orderly and prevent countries from simply grabbing all assets they can when big banks fail[72.] If the currently free market in financial services is mainly maintained as it is, which the EC essentially proposes, the EC could start the discussion on different models on burden sharing could be considered, such as[73];
  - fixed formula between Member States about division of costs;
  - ex post compensation by Member States for the country that has initially taken care of the capitalization of reserves;
  - a European fund which is funded by the Member States and/or the financial sector, for instance via a financial transaction tax.
- The DG Competition of the European Commissions has not been taken into account in the proposed structure while it has important competences when emergency measures need to be taken. In the current crisis, DG Competition has to agree on state aid to rescue banks and requires state aided banks to restructure and sell parts of the financial firms if they remain dependent on state aid. However, DG Competition is not an independent body (eventhough it can introduce legislation without EP and Council voting) but part of the EC which is a political body.
- The supervisory structure will have no mandate to set limits or to control capital flows in Europe and crossing European borders while there is a common European capital market so that capital control measures can only be taken at national level. If need be for the sake of financial stability or the real economy, the European Systemic Risk Council in cooperation with the European System of Financial Supervisors should have the possibility to limit a certain flow of capital.
- It would be more appropriate to consider a financial institution to be cross-border on the basis of its capital flows than on its customers.
- The EC proposals fail to develop ways how the ESRC and the ESA's should also deal with supervision and measures at the global level, and even with colleagues from developing countries where European banks are operating. On a global level all, monetary authorities should at least calculate monetary aggregates that control the amount of capital flows in the money market. This could help as an early warning system to unknown amounts of liquidity which may cause a financial bubble.

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71 Art. "Divided by a common market", The Economist, 2 July 2009.
72 Art. "Divided by a common market", The Economist, 2 July 2009.
73 http://www.minfin.nl/Actueel/Kamerstukken/2009/06/Brief_naar_aanleiding_van_Algemeen_Overleg_over_Europees_toezicht

- The EC failed to propose that supervisors should not only look at the financial stability of the financial firms operating in the EU, but also supervise the risks by the financial industry activities to society and the environment. Such supervision would for instance include guaranteeing sufficient access to finance by all citizens, incorporating environmental and social aspects in lending and investment policies (starting with looking into the implementation of voluntary corporate responsibility inititatives), and promote financial fows to fight climate change while prohibiting that too much capital flows are diverted to very risky speculation.

5.2 Review of the Financial Conglomerates Directive

Background

A financial conglomerate is defined as a provider of services and products in various sectors of the financial markets. The current directive (2002) introduced group-wide supplementary supervision that covers all financial activities identified by the sectoral financial legislation, such as the Capital Requirements Directive (banking) and Solvency II (insurance), and all entities principally engaged in these types of activities. An appointed competent authority must coordinate the assessment at a group-wide level the financial situation of credit institutions, insurance undertakings and investment firms that are part of a financial conglomerate, in particular as regards solvency, risk concentration and intra-group transaction[74.] The directive imposes requirements on:

- Solvency;
- intra-group transactions (all transactions, including movement of assets, between regulated entities within the group) and risk concentration;
- reporting to the various authorities involved in supervision;
- administrative organisation and internal control;
- assessment of the repute and expertise of directors[75].

In July 2009, the European Commission identified as per end 2008, 60 financial conglomerates operating in the EU with their head office within the EU and 8 financial conglomerates with their head office outside the EU[76.] Only for 31 financial conglomerates there are formal colleges of supervisors established[77.] The conglomerates represent approximately around 70% of the banking and insurance business[78.]

The financial crisis has shown that especially financial conglomerates' involvement in worldwide, complex, cross-sectoral and even very speculative activities have spread the financial crisis very quickly across borders while supervisors had too little information about their risks and to little mechanisms for coordinated action. Because some of these conglomerates had become too big to fail, governments had to use trillions of dollars to rescue many conglomerates (while a few were let to go bankrupt) in order to not make the financial system in the industrial world collapse.

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74 European Association of Public Banks, *European Banking and Financial Services Law,* May 2008
75 http://www.dnb.nl/openboek/extern/id/en/all/41-117133.html
76 European Commission, *Identification of Financial Conglomerates,* 24 July 2009.
77 http://ec.europa.eu/internal_market/financial-conglomerates/docs/info-letter/082009_en.pdf
78 http://ec.europa.eu/internal_market/finances/docs/committees/supervision/brady_en.pdf

Decision-making process

Kind of initiative	Date of issue	Consultation	Content	Decision-making	Website
Consultation issued by the Joint Committee on Financial Conglomerates for a review of the directive	Expected autumn 2009	Consultation: ended 28 August 2009	new supervision methods, new scope of financial conglomerates, clarification of definitions	EC, Joint Committee on Financial Conglomerates	http://ec.europa.eu/internal_market/financial-conglomerates/index_en.htm
Legislative proposals by the EC and review of existing regulatory framework (if considered necessary)	Expected early 2010	a more fundamental debate will be prepared, which must include supervisory scope and capital related issues, later in 2010		EC, ECOFIN & EP (econ)	http://ec.europa.eu/internal_market/financial-conglomerates/index_en.htm

The EC works on a review of this directive via calls for advice to the Joint Committee on Financial Conglomerates[79]. This Joint Committee on Financial Conglomerates (JCFC) is an add-on to the Committee European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The members are supervisors from the 27 Members. Besides this, there are observatory members from 3 other countries, the European Commission, the European Central Bank and the three level 3 committees.

Main elements of the consultation by the Joint Committee on Financial Conglomerates (JCFC)

The letters from the European Commission on the review of the Financial Conglomerates Directive point out that several elements that will be central in the review:

- supervision at the level of the holding company;
- clear inclusion of participants and of asset management companies in the identification of financial conglomerates and in the directives scope;
- clear supervisory treatment of participants. The definitions of 'participation', 'close links' and 'group' should be clarified and the issue of participations in non-regulated entities will be addressed;
- identification of risk issues, such as risk concentration, intra group transactions and intra control mechanisms.

[79] In January 2009, the former interim committee on financial conglomerates wa formalized and turned into a European level 3 committee that exists of supervisors for financial conglomerates.

Some comments and criticisms

- The JCFC elaborates in its consultation about the clarification of how to use the concept of "off-balance sheet". As a consequence, the concept is still acknowledged instead of forbidden.
- The JCFC proposes a legal change to allow supervisors to waive small and heterogeneous groups if their risk profile justifies exemption. Moreover, they propose that in case a group only has a participation in another sector there should be a possibility for supervisory discretion not to treat a group as a conglomerate. Both measures seem to relax the supervisory structure as fewer elements will fall under the scope of this directive.
- Interpretations on procedures and definitions, such as ''participants[80]'', have and will lead to regulatory arbitrage by Member States that wish to please, and so attract, the financial services industry.
- The issue of transfer of assets within a group seems to be out of the scope of the review;
- Arrangements on coordination between relevant national and sectoral supervisors are insufficient as they all have their own background and interests. It the cross border financial operations remain as they are, a single European supervisor should be established to prevent regulatory and supervisory arbitrage, avoid conflicts between national supervisors and guarantee a full oversight on the activities of a financial conglomerate.

5.3 Reviewing accountancy rules

Background

In 2005 the EU took a significant step and made the use of International Financial Reporting Standards (IFRS) obligatory for the consolidated financial statements of EU companies which are listed in the EU's stock markets. IFRS accounting should become a global accountancy standard to make it easier to investors around globe to compare consolidated accounts. As a result, the EU has adopted the IFRS without adjustments to it.

The financial crisis has highlighted some limitations of the IFRS fair value principles, or also known as the mark-to-market principles. As a result, the European Union has decided in October 2008 to follow the guidance by the International Accountancy Standards Board (IASB), which recommended temporarily a more flexible application of this principle by supervisors and auditors. This decision was taken by the Council and the European Parliament. Besides the EU, the United States has also relaxed the principles of fair value accounting for the financial sector.

The IASB has again proposed measures to relax the principles of fair value because of the level playing field with the United States. The Financial Accounting Standards Board (FASB) of the US has already taken measures to that provide a more flexible approach that limits the write-down of assets. The IASB proposes that some assets need to be valued via mark-to-market, while other assets are valued via the historical cost price. Loans and securities which have similar characteristics as loans (assets that derive their value only from interest and repayment of principal) will be held at cost, provided banks can show they will hold them for the long term. Everything else, including equities, derivatives and more complicated securities, will be held at fair value[81]. According to experts, only the

[80] Could now be more or less defined as 'ownership of a large amount (20%) of voting rights or capital of an undertaking '
[81] Art. "Marks and sparks", The Economist, 16 July 2009.

best valued assets (triple AAA assets) will qualify to be valued at the historical price. This approach should have the effect of recording only the real losses are record[82]. In addition, the IASB is working on initiatives to improve off-balance-sheet accounting.

Decision-making at EU level

In the European Union, the IASB are endorsed at a regulatory level by the Accounting Regulatory Committee made up of representatives from the Member States and chaired by the European Commission. On the basis of the Commission's proposals, this Committee will decide whether the international standards by the IASB have to be adopted. Its aim is to ensure full transparency and accountability vis-à-vis the Council and Parliament. The Council and Parliament have 3 months to oppose the adoption of the draft regulation[83].

The European Union has decided in October 2008 to follow the guidance by the International Accountancy Standards Board (IASB) and to temporarily apply a more flexible application of fair value principles by supervisors and auditors. This decision was taken by the Council and the European Parliament.

Some comments, criticisms and proposals

- The mark-to-market principles imply that a company assets are valued on the basis of the price they would fetch if they were offered for sale on the market right now instead of what they would be valued were the company to hold on to them until maturation. Such principles have a pro-cyclical effect in times of financial volatility and crisis since companies are extra vulnerable to market valuation. During the financial crisis, financial firms and pension funds have seen their assets plunge in value because of mark-to-market valuation of "sub-prime securities". They had to sell certain assets in this crisis period to ensure that their balance sheet did not show huge losses. As a consequence this writing down of capital and selling of assets has caused extra shocks on the stock exchange which of course further decreased the value of the assets. The losses could have been much lower if the assets were valued on the maturation date basis[84].
- The proposed accountancy difference between fair valuation and at cost price will be arbitrary.
- Off-balance-sheet practices to circumvent reporting requirements and to reduce the amount of capital the financial firms need to have in their reserves, causes system risks for the stability of the financial markets and consequently the real economy. A major problem is that financial supervisors and investors lack oversight. There are many reasons to stop off-balance-sheet accounting and ensure that all assets should be on-balance.
- George Soros proposes to make a distinction in the accountancy rules between commercial and investment banks. Now all investment banks have disappeared this would refer to all commercial banks with substantial wholesale departments and investment banking activities. Commercial banks usually buy assets with the intention to keep them until the maturation date. They should not use mark-to-market accountancy rules. The commercial banks with substantial wholesale departments continually buy and sell assets, they should value on a mark-to-market basis.

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82 http://www.accountant.nl/Accountant/Nieuws/IASB+versoepelt+fair+value+maar+effect+nog+ongewi
83 http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_general_framework/l26040_en.htm
84 http://euobserver.com/9/26943

Annex 1: Terminology

Alternative Investment Fund (AIF) are defined by the European Commission as all funds that are at present not harmonised under the UCITS Directive, see “UCITS”.

Arbitrage relates to the competitive pressure to keep standards low to attract and please business. Regulatory and supervisory arbitrage between countries has contributed significantly to the financial crisis.

Assets are anything with a commercial or exchange value and owned by a business, institution or individual.

Asset stripping is the practice of buying a company in order to sell its assets individually at a profit;

Bank branch based in another country than the head office of the bank: is fully subject to supervisors in the country of the head office.

Bank subsidiaries based in another country than the head office of the bank: are subject to supervision by supervisors from the country of the head office (home supervisors) and those of the host country (host supervisors). Cooperation and decision-making between the two supervisors is somewhat agreed by the Basel Committee on Banking Supervision but is part of the discussions about reform of the supervisory structures

Carbon derivatives, see “derivatives”.

Central counterparty (CCP) is an entity that interposes itself between the counterparties to the contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer.

CEBS is the Committee of European Banking Supervisors. This committee consists of the banking supervisors of the Member States.

CEIOPS is the Committee of European Insurance and Occupational Pension Supervisors. This consists of the insurance and occupational supervisors of the Member States.

CESR is the Committee of European Securities Regulators. This committee consists of the security supervisors of the Member States.

Clearing is the way by which risks are outlined and are mitigated. It’s the process by which by which obligations arising from a financial security are managed over the lifetime of the contract. Until now, credit default swap (CDS) trades – like most over-the-counter (OTC) financial derivatives – are predominantly cleared bilaterally between two contracting parties.

Collateralized Debt Obligations (CDO) consist of a pool of assets and/or mortgage backed securities with loans, bonds or other financial assets as the underlying. A CDO is divided into different risk classes (tranches), whereby "senior" tranches are considered the safest securities. Interest and principal payments are made in order of seniority, so that junior tranches offer higher payments (and interest rates) or lower prices to compensate for additional default risk. This implies that junior tranches will be first in line to absorb potential losses in case of default. Each tranche has its own credit rating based on the potential risks.

Commodity derivatives, see “derivatives”.

Credit default swaps, see “derivatives”.

Credit risk is the chance that the debtor will not repay the loan or other form of debt.

Credit securitization consists in repackaging loans in tradable securities.

Deposit is a sum of money lodged at a bank or other depository institution, such as savings of individuals. The money can be withdrawn immediately or at an agreed time.

Derivatives are financial instruments that are derived from some other assets, credit, foreign exchange, interest rates or commodities, the so-called ‘underlying’. A derivative contract specifies the right or obligation between two parties to receive or deliver future cash flows, securities or assets, based on a future event. The underlying itself is not traded. However, small movements in the underlying value can cause a large difference in the value of the derivatives as a derivative is often leveraged. This implies that the financial assets exceed its capital[85]. The financial crisis has for example shown us the consequence of a decrease in American housing prices, which was an underlying for many derivatives. Derivatives traders speculate on the movement of the value of the underlying. Traders attempt to make profit whether the value increases or moves in the opposite direction. In this latter case, they use derivatives to hedge.

Derivatives can be broadly categorized by:

- The relationship between the underlying and the derivative
  - Futures are contracts to buy or sell a specific amount of commodity, a currency, bond or stock at a particular price on a stipulated future date. A future contract obligates the buyer to purchase or the seller to sell, unless the contract is sold to another before settlement date, which happens if a trader speculates to make a profit or wants to avoid a loss.
  - Options are the right, but not the obligation, to buy (call option) or sell (put option) a specific amount of given stock, commodity, currency, index or debt at a specific price during a specific period of time. Each option has a buyer (called a holder) and a seller (known as the writer). The buyer of such a right has to pay a premium to the issuer of the derivative (i.e. the bank) and hopes the prices of the underlying commodity or financial asset to change so that he can recover the premium cost. The buyer may choose whether or not to exercise the option by the set date.
  - Swaps involve two parties exchanging specific amounts of cash flows against another stream. The swap agreement defines the dates when the cash flows are to be paid and the way they are calculated[86].

- The type of underlying
  - Equity derivatives are derivatives with the underlying existing of equity securities.
  - Foreign exchange/currency derivatives with the underlying existing of a particular currency and/or its exchange rate.

[85] PES, *Hedge funds and private equity, a critical analysis, 2007.*
[86] http://en.wikipedia.org/wiki/Swap_(finance)

- Credit derivatives are contracts to transfer the credit risk of an entity from one counterparty to another. The underlying exists of a bond, loan or other financial asset.
- Credit Default Swaps (CDS) are an insurance contract by which investors protect themselves in case of future defaults. The over-the-counter contracts are used to transfer the credit risk of a reference entity, in which the protection buyer pays a premium and the protection seller makes a payment in the event of a default by the reference entity87. Besides this, there exist so-called "naked" credit default swaps, which give purchasers the ability to speculate on the creditworthiness of a company without holding an underlying bond88. The overall CDS market has grown many times the size of the market for the underlying credit instruments and causes systemic risks.
- Commodity derivatives have commodities, such as oil and agricultural products, as the underlying. The prices of commodities have become a target of speculation and are now instruments for investors to diversify portfolios and reduce risk exposures.
- Carbon derivatives have pollution permits as the underlying. The emission trading is based on the principle that polluting companies buy carbon credits from those who are polluting less somewhere in the world and have therefore pollution permits to sell. Financial engineers already developed complex financial products, such as derivatives, to speculate and such products are now seen as a potential financial bubble.

- The market in which they trade
  - Exchange traded derivatives are products that are traded via specialized derivatives exchanges or other exchanges. A derivatives exchange acts as an intermediary to all related transactions, and demands a deposit from both sides of the trade to act as a guarantee to potential credit risks, the so-called Initial margin.
  - Over The Counter (OTC) trading is an exchange directly between the buyer and seller. Around 85% of the derivatives transactions are over-the-counter. They are not listed on the exchange and there is no trade through third parties.

Diversification of portfolios takes place because the financial sector considers it not prudential to put too many eggs in one basket, if the basket breaks, the whole business might be lost. As a consequence, they combine pool and restructure all sort of financial products.

ESCB (European System of Central Banks) is composed by the European Central Bank (ECB) and the national central banks of all 27 EU Member States.

Equities are ordinary share

Fair value accounting (or mark-to-market accounting) is a principle of the International Financial Reporting Standard (IFRS) and implies that a company assets are valued on the basis of the price they would fetch if they were offered for sale on the market right now instead of what they would be valued were the company to hold on to them until maturation.

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[87] European Parliament (Policy Department Economic and Scientific Policy), *Financial supervision and crisis management*, 2007, p. 69

[88] http://www.ft.com/cms/s/0/1157e11e-6d7c-11de-8b19-00144feabdc0.html?ftcamp=rss

Financial bubbles exist if assets or products are traded with highly inflated values, such as American housing prices.

Futures, see derivatives.

Hedge funds are activist shareholders, which use a certain amount of shares to influence the outcome of the general meeting of shareholders and so the long-term strategy of a company with the aim to make short- term profits by a movement of the market value of the shares. The sustainability of the company on the long-term is inferior. Hedge funds use speculative strategies, such as short-selling, leverage and derivatives, to obtain the highest possible return on their investments. Moreover, hedge funds can be high-leveraged up to an amount of 11.5 times, as we have seen with the hedge fund LTCM.

Incurred losses are the losses that have occurred within a stipulated time period whether paid or not.

Leverage is among others used by hedge and private equity funds. This means that they finance their operations more by debt than by money they actually own. The leverage effect is the difference between return on equity and return on capital employed (invested). By using leverage a company can deliver a return on equity exceeding the rate of return on all the capital employed in the business.

Leverage buy-outs is the main practice of private equity funds. It implies that a healthy company is bought with borrowed money. The ratio of what is invested by the fund and what is borrowed money for a buy-out is usually around 25% (invested) to 75% (borrowed)[89]. As a result, a company is saddled with an enormous debt and the private equity firm starts lending money to repay the money that was borrowed to buy the company. The interest payments are at the cost of the company and are often eligible for tax deduction. As a result of the amount of interest payments, the balance sheet of the company is negative. Such an artificially created loss often leads to a tax rebate. Moreover, the artificially created losses are used as an argument to cut costs at the expense of workers, research and development, environment or consumers. The company structure is being overhauled and certain company divisions and assets that are soled as PE firms consider it unnecessarily tying up capital[90]. After such an overhaul the company is sold to the highest bidder.

Mark-to-market or fair value accounting refers to the accounting standards of assigning a value to a position held in a financial instrument based on the current fair market price for the instrument or similar instruments.[91] It could be explained as the value of the securities e.a. when they would be sold off at the time of the accounting report, while most securities or other investments are intended to be retained for a longer period during which the value of the positions could change.

Moral hazard refers to the principle that in good times the profits of the financial service industry are privatized, while the losses in case of emergency are socialized. Moral hazard has contributed to the practices of excessive risk-taking by the financial sector.

Mutual funds are open-ended funds operating by an investment company, which raises money from shareholders and invests in a (diversified) group of assets, in accordance with a stated set of objectives[92].

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[89] PES, idem.
[90] PES, idem.
[91] http://en.wikipedia.org/wiki/Mark-to-market_accounting
[92] http://www.investorwords.com/3173/mutual_fund.html

Naked short-selling, see "short-selling".

Options, see "derivatives".

Public trading: generally refers to regulated markets and multilateral trading facilities subject to public disclosure requirements (EC consultation doc on derivatives, July 2009).

Off-balance sheet practices refer to certain assets and debt that are not on the balance sheet of the company, has contributed to the lack of oversight by supervisors. Banks have traditionally used off-balance-sheet practices to avoid reporting requirements or to reduce the amount of capital they needed to hold to satisfy regulatory requirements[93].

Over-the-counter, see "derivatives".

Prime brokerage is a package of professional services to hedge funds and other large institutional investors mainly provided by investment banks, such as Morgan Stanley and Goldman Sachs. Those services include financing to facilitate leverage, securities lending between hedge funds and institutional investors, clearing and settlement of trade, capital introduction by introducing hedge fund clients to qualified hedge fund investors who have an interest in exploring new opportunities to make hedge fund investments, risk management advice and operational support. Cash lending to support leverage and securities lending to facilitate short selling are the main prime brokerage services of which more than 90% is based in London. Their revenues are typically derived from three sources: spreads on financing (including stock loan), trading commissions and fees for the settlement of transactions done away from the prime[94].

Private equity funds vary from hedge funds as they operate in a different way as an activist shareholder. Private equity funds have generally speaking two types of activities. They provide venture capital for start-up firms and small business with growth potential that look for investors. However, their most substantial and striking activities are the leveraged buy-outs, see "leverage buy-outs". Private equity firms have a short term focus as they wants their investment back as soon as possible with the highest return as possible. In the first half of 2006 private equity leveraged buy-outs have got 86% of their investment back in just 24 months engagement in the target company[95]. The biggest five private equity deals involved more money than the annual budgets of Russia and India[96].

Procyclicality implies that the value of the good, service or indicator tends to move in the same direction as the economy, growing when the economy grows and declining when the economy declines. In particular, the financial regulations of the Basel II Accord have been criticized for their possible procyclicality. The accord requires banks to increase their capital ratios when they face greater risks. Unfortunately, this may require them to lend less during a recession or a credit crunch, which could aggravate the downturn. A similar criticism has been directed at fair value accounting rules[97].

Re-securitizations have underlying securitization positions, typically in order to repackage medium-risk securitization exposures into new securities. Because of their complexity and sensitivity to correlated losses, re-securitizations are even riskier than straight securitizations

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93 Reuters, *US to study impact of new off-balance-sheet rules* , 19 August 2009, http://www.reuters.com/article/fundsFundsNews/idUSN1946918220090819?rpc=77
94 http://en.wikipedia.org/wiki/Prime_brokerage
95 PES, idem, p. 18.
96 PES, idem.
97 http://www.answers.com/topic/procyclical

Securitization is the process of converting a pool of illiquid assets, such as loans, credit card receivables (Asset Backed Securities) and real estate (Mortgage Backed Securities), into tradable debt securities. These new sophisticated instruments were supposed to refinance pool of assets, to diminish risks and to enhance the efficiency of the markets, but they resulted in increasing the risks by spreading "toxic assets" throughout the financial system.

Securities lending is the borrowing of securities, which primarily takes place between investors, such as hedge funds, and institutional investors. The latter do not want to sell the securities in the short run and do like the fees they receive for lending their stocks. Besides short selling, the practice of securities lending may be used for activist practices during the general meeting of shareholders. A lender of a security loses its voting rights to the borrower who may use it for activist short-term goals.

Short-selling. This is the practice of selling a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock at a lower amount than the price which they sold short. So, short sellers make money if the stock goes down in price[98]. If many market participants go short at the same time on a certain stock, they call down an expected drop in prices because of the growing amount of stocks that have become available. Such practices hold the risk of market manipulation.

Special Purpose Vehicles (SPVs) or Special Investment Vehicles (SIVs) are legal entities created, sometimes for a single transaction, to isolate the risks from the originator. As a result, financial firms set up an SPV/SIV in which they usually do not contribute risk capital. The SPV primarily holds investments of other financial firms or other (institutional) investors. The financial firm that set up the SPV/SIV receives fees for their services that have been agreed in the memorandum of association or the statutes of the SPV/SIV.

Stealth acquisitions are acquisitions of large stakes in companies without required notifications to the market and the company through the use of cash-settled derivatives[99].

Swaps, see “derivatives”.

Trading book refers to the portfolio of financial instruments held by a brokerage or bank. The financial instruments in the trading book are purchased or sold to facilitate trading for their customers, to profit from spreads between the bid/ask spread, or to hedge against various types of risk[100]. The trading book mainly consists of all the financial instruments that a bank holds with the intention of re-selling them in the short term, or in order to hedge other instruments in the trading book.

UCITS (Undertakings for Collective Investment in Transferable Securities) are investment funds established and authorized in conformity with EU legislation. The UCITS Directive lays down common requirements for the organisation, management, free movement, liquidity and oversight of those funds[101].

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[98] PES, idem.
[99] FEPS, Regulating hedge funds, private equity and alternative investment vehicles, April 2009.
[100] http://www.investopedia.com/terms/t/tradingbook.asp
[101] http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/510&format=HTML&aged=0&language=EN&guiLanguage=fr

Annex 2: Decision-making procedures in the EU about financial services[102]

The European Commission (EC)

Regarding financial services, the European Commission is the only institution with the right of initiative. The Commission is empowered to initiate;

- Directives. A directive is a legislative act that requires Member States to achieve a particular result with a certain amount of leeway as to the exact rules to be adopted. The EU does not dictate the means of achieving the result.
- Regulations. A regulation is a legislative act that immediately becomes enforceable as law in all Member States at the same time. Member States do not have any leeway as to how to implement the act.
- Recommendations. A recommendation has no legislative power and is non-binding to Member States. Though it gives a 'recommendation' on a certain policy.
- Communications. A communication by the European Commission mainly functions to set out some ideas and considerations of the Commission of how to wishes to act in the future on a certain topic. Communications include:
  - white papers are documents containing proposals for Community action in a specific area. In some cases they follow a Green Paper published to launch a consultation process at European level. When a White Paper is favourably received by the Council, it can lead to an action programme for the Union in the area concerned[103].
  - green papers are documents published by the European Commission to stimulate discussion on given topics at European level. They invite the relevant parties (bodies or individuals) to participate in a consultation process and debate on the basis of the proposals they put forward. Green Papers may give rise to legislative developments that are then outlined in White Papers[104].

Directives and regulations on financial services need to be adopted by the European Parliament and the Council. Recommendations and communications have no binding powers so neither the Council nor the European Parliament adopts them. Though both institutions reflect on them and usually provide the EC with their opinions.

On taxation the European Parliament needs to give an advice to the Council but has no legislative powers.

The European Commission consists of 18 Directorates-General of which DG Internal Market and Services, DG Competition, DG Economic and Monetary Affairs and DG Taxation and Customs Union are the most relevant in the field of financial services.;

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[102] See also: M. Vander Stichele, Financial regulation In the European Union - Mapping EU decision making structures on financial regulation and supervision, December 2008, http://www.eurodad.org/uploadedFiles/Whats_New/Reports/EUMapping_Financial_Regulation_FINAL.pdf

[103] http://europa.eu/scadplus/glossary/white_paper_en.htm

[104] http://europa.eu/scadplus/glossary/green_paper_en.htm

- DG Internal Market and Services seeks to remove unjustified obstacles to trade, in particular in the field of services and financial markets[105]. Regarding among others financial services and markets, capital markets, company law, accounting and corporate governance this DG is responsible for policy initiatives and legislative proposals. Moreover, DG Internal Market and Services not only promotes the strengthening of the internal market but also has the responsibility to initiate initiatives on supervision and control over the internal market in financial services.

  Current Commissioner Charlie McCreevy (Ireland, conservative)

- DG Competition has the competence to enforce the competition rules of the Community Treaties (antitrust, mergers, State infringements and State aid control). Moreover, this DG works also on the development of relevant policies, sector inquiries and market monitoring, competition advocacy and international cooperation in the field of competition[106].

  Current Commissioner Neelie Kroes (the Netherlands, liberal)

- DG Economic and Monetary Affairs fosters the Economic and Monetary Union both inside and outside the European Union, by conducting economic and budgetary surveillance, providing policy assessment and advice, promoting appropriate policy action and advancing economic policy coordination[107].

  Current Commissioner Joachim Almunia (Spain, socialist)

- DG Taxation and Customs Union mainly tackles cross-border tax obstacles to individuals and companies, develops and defends the customs union, facilitates a better cooperation between Member States and responds to international challenges in this area[108].

  Current Commissioner László Kovács (Hungary, socialist)

Organisational criticism

- A main element of criticism concerns the functioning of DG Internal Market and Services, which has to promote the internal market in financial services and is responsible for controlling and supervising the internal financial services market . As a consequence, there is a conflict of interests as it could be necessary to limit the development of the internal market in order to improve the stability and regulation of the financial services market, for example regarding the amount of capital flows.

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105 http://ec.europa.eu/dgs/internal_market/index_en.htm
106 http://ec.europa.eu/dgs/competition/mission/
107 http://ec.europa.eu/dgs/economy_finance/organisation/mission_en.pdf
108 http://ec.europa.eu/taxation_customs/common/about/welcome/index_en.htm

The European Parliament (EP)

The European Parliament is the directly-elected body of the European. The Parliament has among others legislative, budgetary and supervisory powers (such as inquiries, written and oral questions to the European Commission).

The Members of European Parliament draw resolutions via legislative and non-legislative own initiative reports. On proposals for financial services directives and regulations, the European Parliament usually acts as a co-legislator together with the Council. In addition, the Parliament has, just as the Council, the political power to ask the Commission to come forward with legislative proposals at a fixed time (rule 39 of the rules procedure of the European Parliament[109]).

If the Commission launches a recommendation and/or communication, this will usually be considered by the European Parliament via non-legislative own initiatives' reports. The Commission has to react on the content of those reports but the content has, just as the recommendation or communication itself, no binding consequences.

In the area of financial services and markets, tax and corporate governance, the main parliamentary committees, which deal with these issues, are the Economic and Monetary Committee and the Legal Affairs Committee. Each committee has its own competences:

- Economic and Monetary Committee (ECON)
  - the economic and monetary policies of the Union, the functioning of the Economic and Monetary Union and the European monetary and financial system (including relations with the relevant institutions or organisations);
  - the regulation and supervision of financial services, institutions and markets including financial reporting, auditing, accounting rules, corporate governance and other company law matters specifically concerning financial services[110].
  - the free movement of capital and payments (cross-border payments, single payment area, balance of payments, capital movements and borrowing and lending policy, control of movements of capital originating in third countries, measures to encourage the export of the Union's capital);
  - the international monetary and financial system (including relations with financial and monetary institutions and organisations);
  - rules on competition and State interventions or public aid;
  - tax provisions.

  New Chair of ECON: Sharon BOWLES, Group of the Alliance of Liberals and Democrats for Europe

- Legal Affairs Committee (JURI)
  - the interpretation and application of European law, compliance of European Union acts with primary law, notably the choice of legal bases and respect for the principles of subsidiary and proportionality;

[109] http://www.europarl.europa.eu/sides/getDoc.do?type=RULES-EP&reference=20090309&secondRef=RULE-039&format=XML&language=EN
[110] http://www.europarl.europa.eu/activities/committees/homeCom.do?language=EN&body=ECON

- the interpretation and application of international law, in so far as the European Union is affected;
- the simplification of Community law, in particular legislative proposals for its official codification;
- the legal protection of Parliament's rights and prerogatives, including its involvement in actions before the Court of Justice and the Court of First Instance;
- Community acts which affect the Member States' legal order, namely in the fields of: (a) civil and commercial law, (b) company law, (c) intellectual property law, (d) procedural law;
- measures concerning judicial and administrative cooperation in civil matters;
- environmental liability and sanctions against environmental crime;
- ethical questions related to new technologies, applying the procedure with associated committees with the relevant committees;
- the Statute for members and the staff regulations of the European Communities;
- privileges and immunities as well as verification of EP Members' credentials;
- the organisation and statute of the Court of Justice;
- the Office for Harmonisation in the Internal Market[111].

If the Commission has initiated a proposal to the European Parliament, it will be considered by the various relevant parliamentary committees. One committee will be appointed to be the responsible committee and others may provide this committee with an opinion on certain elements of the proposals. Sometimes parliamentary committees share the competence over a proposal which implies that the lead committees takes automatically some of the comments made by the other committee.

The 'political games' between the EP members and their political parties, start with the division between the parliamentary committees regarding who writes which EP reports. For example, it is assumed that more social or environmental friendly christen-democrats and liberals take seat in the employment and environment committees. As such, it can be helpful for social-democrats and greens if those committees become the leading committees on certain proposals because these committees vote on their own amendments as well as on the opinions of the other committees before the final report on that proposal goes to the plenary session of the EP where the final vote is casted.

If a proposal is for example appointed to the ECON, it is to be decided which political group may have to write the report. The coordinators of the political groups usually start negotiating with each other and distribute the proposals on the basis of starting points. Each political group has a certain amount of points based on their size. If several groups wish to have a certain report it is up to the coordinator to negotiate and to 'pay' more points. After the meeting of coordinators, the coordinator of political group divides the responsibilities for the reports among the (substitute) members of that group in a certain parliamentary committee. Because of national interests and difference in ideology, this may also be a sensitive game to appoint a rapporteur. The other political groups also appoint a shadow-rapporteur who will be responsible to follow the report and negotiate on behalf of the political group.

These same procedures are being played for the division of opinions on proposals and the appointment of (shadow)-rapporteurs on those opinions.

[111] http://www.europarl.europa.eu/activities/committees/homeCom.do?language=EN&body=JURI

Next, the rapporteur drafts a report with help of the secretariats of the parliamentary committees. The draft report is to be discussed in the relevant committee. After this discussion, the chair of the committee sets a deadline for amendments on the own-initiative report of the Parliament or on the legislative proposal. Those amendments are discussed in the committee and attempts will be made by (shadow-) rapporteurs to get compromise amendments between the political groups. During this formal procedure, backroom discussions take place and the political groups organize (horizontal) working groups on the basis of the parliamentary committees in which issues are being discussed in an attempt to have a common position. Next, the vote in the leading committee takes place with political battles on the voting lists (order of vote of the amendments), the split votes within amendments, oral amendments, votes on the proposed amendments by other committees that have made an opinion, etc.. All these procedures result in a final report by the leading committee, which then goes to plenary. A deadline is then being to make plenary amendments either by the political groups or with at least the support of 30 Members of Parliament. In the case of legislative reports, the Council, Commission and representatives of the Parliament (rapporteurs, coordinators etc) organize very influential informal trialogues in an attempt to get a common position in first reading, so before the plenary vote of the Parliament. If this succeeds, the rapporteur tables the necessary amendments to have the text agreed after a successful vote.

If there is no agreement between Council and Parliament or no majority in Parliament for this position, there will be a second reading on the proposal. This implies that the European Parliament will again start a procedure on parts of the proposal where is not yet an agreement reached. Besides this, the Commission, Council and representatives of the Parliament again negotiate during trialogue meetings in an attempt to reach a common position.

If Council does not approve all the amendments of the European Parliament adopted at its second reading, the conciliation procedure starts in a last attempt to agree. The conciliation Committee is made up of twenty-seven Members of the Council or their representatives and an equal number of representatives from Parliament who make up the EP delegation. If there is an agreement, this text shall also be voted without amendments by the plenary of the EP.

More detailed information on how decision making on financial issues take place at the European level, can be found in the report “Financial regulation In the European Union - Mapping EU decision making - Structures on financial regulation and supervision”.[112]

[112] http://www.eurodad.org/uploadedFiles/Whats_New/Reports/EUMapping_Financial_Regulation_FINAL.pdf