February 2012

This newsletter is published by SOMO and WEED. It is part of a common project on EU regulation of financial markets. Other project partners that contribute to the newsletter series are: AITEC, Glopolis, New Economics Foundation, Vedegylet.

Subscribe to the EU Financial Reforms newsletter here >

Editorial: The last year to learn from the financial crisis?

The New Year has started and the old has ended, and we are still in a permanent state of (financial) crisis. After the G20 summit in November 2011, which was dominated by the later abandoned Greek referendum, things have even become worse. With its "fiscal pact" decided at the end of the January EU summit, the EU is now heading towards the German solution to the crisis: harsh fiscal discipline financed by wage and social benefit cuts, which will have a severe negative social as well as economic impact. While even the International Monetary Fund was raising concerns about the likely success of these austerity measures, Germany continues to champion them for the EU.

Financial reforms will also stay on the EU agenda throughout 2012 and beyond. Major reforms begun in 2010 (!), such as the European Market Infrastructure Regulation (EMIR), have still not have been finalised. Other issues are again on the agenda, such as Capital Requirements (CRD IV), implementing the new international Basel III standards, and credit rating agencies, where the Commission intends to take measures that would really affect their business.

In this newsletter:

Contact us:

visit the SOMO website
m.vander.stichele@somo.nl
+31 (0)20 639 12 91

visit the WEED website
peter.wahl@weed-online.org
+49 (0)30 2758 2616

In both cases, the existing directives and regulations will be amended. Negotiations started at the end of 2011 on the revised Markets in Financial Instruments Directive (MiFID), one of the biggest outstanding reforms, and this reform will not likely be finalised before 2013. Amongst others, (commodity) derivatives, dark pools, and high frequency trading will be affected by this important reform. Finally, the Financial Transaction Tax (FTT) stands a good chance of being implemented.

However, the momentum for reform in the fallout of the financial crisis is vanishing, and might evaporate altogether in 2012. Remembrance of crises, as history tells us, does not last very long. The debts caused by the financial crisis are not yet paid, and are, in fact, still getting bigger; however, the true reasons behind this are at risk of being forgotten. The financial industry and its lobbyists are trying to promote the story that the financial sector has paid enough and that regulation is now sufficient – despite the fact that true reforms have never taken place.

Summaries of the articles in this newsletter

Fourteenth EU Crisis Summit Decides on Fiscal Pact

Since the outbreak of the crisis in 2008, the EU has held 18 summits. But the efforts to get the problems under control are still far from successful. While the recent summit on 31 January decided on the establishment of a new rescue fund, the European Stability Mechanism (ESM) and a fiscal pact, the situation in Greece has worsened considerably. At the same time, Portugal, Spain, Ireland and Italy remain under strong pressure from financial markets. Signs, that not only Greece but also Portugal might be at the brink of default without a fresh influx of money, are increasing.

For the full detailed article see below.

Debate on EU Financial Transaction Tax in the EU Increasingly Heated

The debate in Europe on the FTT is becoming increasingly heated. During his December 2011 visit to Berlin, British Prime Minister Cameron declared that the UK would not accept a European FTT, as had been proposed by the EU Commission in a draft directive (see October 2011 newsletter). Former Prime Minister Mayor even spoke of a “heat-seeking missile geared towards the City of London.” At the World Economic Forum in Davos at the end of January, Cameron called the FTT a mad idea. In the meantime German Chancellor Merkel declared that she would consider the implementation of the FTT in the Euro zone, even if the UK did not participate. In the meantime, Sarkozy has presented a draft law for the unilateral introduction of the FTT in France.

For the full detailed article see below.

MiFID revision: the struggle to regulate commodity, dark and high speed trading accelerates

The MiFID review is the latest important financial market law that is being revised by the European Commission after the financial crisis. It will dominate the discussion throughout 2012. The next important step will be the release of the draft report by the Parliament's Rapporteur at the end of April 2012, for which he has collected views from stakeholders. It remains to be seen if the Parliament will take up the critique of civil society to take a stricter position on harmful commodity speculation than in the Commission's draft.

For the full detailed article see below.

Will the EU be able to decide on a major bank reform in the coming months?

Following the adoption of the new international standards ("Basel III") on capital reserves banks have to hold and in the context of the continuing banking crisis, the EU is currently deciding on how to revise its Capital Requirements Directive ("CRD IV"). After the European Commission had released its proposals summer last year, the European Parliament and the EU Council of Ministers are now debating their positions on which both sides will start voting and deciding from March 2012 onwards.

While the new provisions would improve the stability of the banking system to a certain extent, critics show how they are insufficient to make banks really safe and sustainable. Remaining possibilities for low capital buffers, insufficient self-risk assessment mechanisms and high levels of borrowing by banks (leverage) will not make banks strong enough in times of further crises. Beyond the technical shortcomings of what is currently on the table, there are still no proposal for a general obligation to use capital in a sustainable, non-speculative way, and to fundamentally eliminate the danger of banks being "too big to fail".

For the full detailed article see below.

Credit Rating Agencies: will the oligopoly be tackled?

In November of last year, the European Commission (EC) unveiled its draft regulation to reform the credit rating industry and review the regulation already in force since 2009. Whilst many of the EC's initial ideas, such as prohibiting the rating of countries that are undergoing bailouts, have been dropped, many significant changes will be introduced. Most importantly, issuers will be required to rotate the credit rating agency (CRA) that they use on a regular basis.

It is hoped that this will foster competition and encourage new entrants in a market currently dominated by only three companies. However, critics argue that this may result in a lowering of standards, as agencies fiercely compete for business by generously inflating ratings. (Issuers want their debt to be highly rated, as this lowers their cost of funding, and issuers are currently the ones who pay CRAs for ratings). The legislation is expected to come into effect in 2013.

For the full detailed article see below.

Fourteenth EU Crisis Summit Decides on Fiscal Pact

By Peter Wahl, WEED

photo from Flickr by Junge Union Deutschlands

Since the outbreak of the crisis in 2008, the EU has held 18 summits. But the efforts to get the problems under control are still far from successful. While the recent summit on 31 January decided on the establishment of a new rescue fund, the European Stability Mechanism (ESM) and a fiscal pact, the situation in Greece has worsened considerably. At the same time, Portugal, Spain, Ireland and Italy remain under strong pressure from financial markets. Signs, that not only Greece but also Portugal might be at the brink of default without a fresh influx of money, are increasing.

The fiscal compact

The German government, backed by some other European countries such as the Netherlands, Finland and Austria, has pushed for more than a year for an agreement to increase fiscal discipline in the Euro zone at least, if not in the whole EU-27 (see the July 2011 newsletter). The January summit has now adopted a Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The UK and the Czech Republic are not participating in this fiscal compact. As there is no consensus in the EU-27, the new project has to be a multilateral agreement outside the legal framework of the EU.

The basic idea of the fiscal pact is what the Germans call a “debt brake”, i.e. a ceiling for public debt to be anchored in the constitution of each country. Although the Maastricht Treaty (1992) already provides for such regulations (60% of debt stock to the GDP and 3% of public expenditure), governments did not stick to these, even before the crisis. The new agreement, however, envisages multilateral control of fiscal policy and sanctions. The pact has yet to be ratified.

The *European Stability Mechanism* (ESM) has also been adopted and will enter into effect on 1 July this year (for the full text see here). The ESM is a fund that financially rescues member states in difficulties, and disposes of 700 bn. euros and a lending capacity of 500 bn. euros. This would be enough to rescue smaller economies such as Greece, Portugal and Ireland. Should major economies like Italy run into difficulties, the ESM would not be sufficient. Help from the ESM is tied to strict structural adjustment with harsh austerity measures, privatisation and all the other factors from the neo-liberal textbook. It replaces the *European Financial Stability Facility* (EFSF), a smaller provisional fund, which had been established in July 2011.

A pyrrhic victory for Merkel

Few days before the summit, the German Finance Ministry launched the idea of installing a commissioner for Greece – and in other countries in the future – who would have the right to block the Greek government’s expenditures, in effect removing the country’s sovereignty. There was a strong rebuttal of the idea, which would have turned Greece into a kind of protectorate and liquidate the rest of democracy in European crisis management. Even Sarkozy, Merkel’s closest ally, publicly rejected the proposal.

As a result, anti-German feelings increased. Beyond the historical background, this is a dangerous trend that could increase nationalism and the already existing centrifugal tendencies in the EU. A glance at Hungary shows how thin the ice is. But also from an economic standpoint, the German government’s dogmatic belief that the main reason for the debt crisis is a lack of fiscal discipline is leading the Euro-zone into a deadlock.

The effects of the neo-liberal receipt strategy can be studied in Greece and Portugal. After dramatically cutting public expenditure, reducing pensions, lowering wages, increasing mass taxation and other austerity measures, the economies in these countries are on the brink of collapse, with a risk of political destabilisation. Although this had been predicted in prominent critiques of the hardcore neo-liberal structural adjustment by such luminaries as Nobel Prize winner Stiglitz, the summit has now decided for more of the same therapy. For instance, it now argues that minimum wages in Greece should be lowered from 750 to 600 Euro. Nobody can live on such a ridiculously low amount.

The crisis management is not only piecemeal and muddled, but in itself is becoming an additional factor of the worsening crisis. Neither Greece nor Portugal nor other economies under threat will be able to grow out of the crisis under the auspices of such a strategy. On the contrary, they will be pushed deeper into ruin. Germany, which is one of the main beneficiaries of the euro, is risking the disruption of the Euro zone, and the fiscal compact might prove to be a pyrrhic victory for Berlin.

Debate on EU Financial Transaction Tax in the EU Increasingly Heated

By Peter Wahl, WEED

The debate in Europe on the FTT is becoming increasingly heated. During his December 2011 visit to Berlin, British Prime Minister Cameron declared that the UK would not accept a European FTT, as had been proposed by the EU Commission in a draft directive (see October 2011 newsletter). Former Prime Minister Mayor even spoke of a "heat-seeking missile geared towards the City of London." At the World Economic Forum in Davos at the end of January, Cameron called the FTT a mad idea. In the meantime German Chancellor Merkel declared that she would consider the implementation of the FTT in the Euro zone, even if the UK did not participate. In the meantime, Sarkozy has presented a draft law for the unilateral introduction of the FTT in France.

Unilateral FTT in France

The most recent coup is French President Sarkozy's initiative to implement the FTT unilaterally in France. He argues that those who want the FTT globally or in the EU-27 would in reality be against the tax, because it is obvious that such a broad consensus will not be possible over the next years.
The law should be passed before the end of the legislation period, which is 15 March, and implemented in August of this year.
According to the leaked draft law (see full text) the main elements of the French tax are the following:

- The purchase of shares of French firms with a capitalisation above one billion Euro will be taxed at a rate of 0,1%.
- High Frequency Transactions with manipulative character (cancelled and modified transactions which push up prices)
- Credit Default Swaps for sovereign bonds will be taxed at 0,01%.

The estimated revenue is 1 bn. Euro. The law is explicitly open for enlargement, if there is a broader solution with the Euro zone.
With regard to avoidance, the French project is close to the British Stamp Duty which is very difficult to circumvent. As all British shares have to be emitted through the electronic information and settlement platform CREST, even transactions in Singapore, New York or Johannesburg can be taxed. If a trader wants to leave CREST, he has to pay an exit fee, which is three times higher than the tax (1.5%).
Sarkozy's move is very much determined by the French election campaign. He is clearly trailing behind the Socialist candidate

Hollande in opinion polls. At the same time, he wants to increase the VAT. In order to avoid the impression of being merely the "President of the rich" he is very much interested in implementing the tax before the election (the 1st round of which will be on 22 April, 2nd round 6 May). Nevertheless, the French initiative keeps the momentum and breaks with the dogma, that only multilateral action would be feasible.

Opponents to FTT launch campaign
Encouraged by the British resistance, the finance lobby and their political proxies are strongly campaigning against the FTT. They use nearly half of a page of the more than 1,000 pages of the impact assessment presented by the EU Commission, in which decreasing growth and job loss are predicted as a result of the FTT. Though the authors of the impact assessment write that their analysis is based on insecure data and must be taken with reservations, the opponents are fully exploiting it.
At the same time, insurance companies are launching calculations according to which pensioners would be hit very hard by the FTT. For instance, the Dutch company APG, which provides pension funds services, administering the pensions of over 4 million people in the Netherlands, issued a memorandum saying that the Dutch pension fund sector would have to pay 3 billion euros per year, equal to approximately 6% of the tax revenues European Commission is aiming to collect for the entire EU. Although APG has meanwhile withdrawn its figures, the arguments continue to circulate in the media.

EU Commission takes over the civil society critique of impact assessment
As a reaction, EU Commissioner Semeta has written an article that was published in several languages in several European countries. In it, he rebuts the arguments of opponents. He talks about "myths", declaring that the FTT would increase growth and create jobs if the revenues would go into infrastructure investment, for instance. He also announced that the Commission would soon present new figures on the effects of the FTT.

What will happen next?
The official procedure for the EU directive is to officially state before summer break that the initiative has either failed due to lack of consensus in the EU-27 or that the UK has changed its mind and negotiations will continue.
If the first case should hold true, the battle for a Euro-zone solution will begin. In the second case, the question will be how far the UK will be able to water down the directive from Brussels.

MiFID revision: the struggle to regulate commodity, dark and high speed trading accelerates

By Markus Henn, WEED

The MiFID review is the latest important financial market law that is being revised by the European Commission after the financial crisis. It will dominate the discussion throughout 2012. The next important step will be the release of the draft report by the Parliament's Rapporteur at the end of April 2012, for which he has collected views from stakeholders. It remains to be seen if the Parliament will take up the critique of civil society to take a stricter position on harmful commodity speculation than in the Commission's draft.

As reported in the previous newsletter, the Commission had published its draft proposals for the revision of the Markets in Financial Instruments Directive (MiFID) on 20 October 2011, proposing a revision of the directive and a new regulation. The MiFID review, amongst others, deals with regulating commodity derivatives, bringing light to dark markets by extended transparency rules for all financial instruments, requiring financial institutions to trade derivatives at multilateral trading venues, and toughening its stance on automated ("algorithmic") high-speed ("high-frequency") trading.

While no one knows how long the European Parliament and the EU Council of Finance Ministers will now need to reach a final decision, the first steps have been taken: the Parliament intends to take a vote in the plenary in (late) autumn, with the decisive vote in the ECON already in July or September (see calendar for more dates). The Rapporteur, who will coordinate the Parliament's position, is the conservative, Christian democratic MEP Markus Ferber. Ferber has now already undertaken the first steps to let stakeholders take part in the law making process: on 5 December 2011, a public hearing took place in Brussels, at which in addition to industry lobbyists, two civil society representatives from CIDSE and from Finance Watch took part, raising concerns about insufficient regulation, particularly for opaque over-the-counter, high-speed and commodity trading.

After the hearing, Ferber requested written comments on a questionnaire he set up. While this is a welcomed step, the questionnaire seemed to concentrate on the needs of industry participants rather than on society as a whole, and to prevent people from raising issues that are not addressed in the questionnaire and the draft proposals by the Commission. Several civil society organisations answered the questionnaire. To push even further for sufficient measures against (excessive) speculation in commodity markets, the World Development Movement, Friends of the Earth Europe and WEED launched an internet petition calling for detailed changes to the MiFID, especially to delete a provision that "alternative arrangements" could be used instead of position limits – which would mean that the limits could be easily set apart – and to allow for preventive measures by the authorities to tackle speculation. The petition was signed by more than 8,000 supporters. When handing in the petition to Ferber, he promised the organisers to take the issue of commodity speculation into account. He obviously does not want to be captured by the finance industry. He uttered his reluctance to exemptions and will think about strengthening the position limits and the high frequency trading regulations. Furthermore he is worried about the many rules that are on "level 2", which means they are delegated by MiFID to the Commission and the authorities. Hopefully, his words and concerns will be followed by deeds.

The EU Council of Finance Ministers, which represents the Member States' governments, has also begun to discuss its position. It is already becoming obvious that the British government will try to turn away as much regulation as possible to favour the British financial market. However, other governments, including Germany's, are also not clearly committed to regulating commodity derivatives, high-speed and dark markets. The German interest in protecting the Frankfurt exchange from British competitors already became clear in the discussion about the European Market Infrastructure Regulation (EMIR) last year. It will be particularly interesting which role the German Rapporteur Ferber will play in this debate and whose interests he will serve. France is obviously pushing for regulation, even though part of its fierce rhetoric is certainly being caused by the French elections, which will be held in April 2012. The Danish presidency will have a though job in bringing these position together.

Some other contentious issues are:

- the creation of a new kind of lightly regulated "organized trading facility" (OTF). The commission intends for this to bring back large parts of the rather unregulated "over the counter" (OTC) markets to multilateral and regulated trading venues such as an OTF, or also other existing types of venues. However, it seems rather likely that the OTFs will deduct trading from the better-regulated multilateral trading facilities and regulated markets without diminishing OTC trading.
- the exemptions from the obligation to apply MiFID for certain (financial and non-financial) operators trading in the derivatives market. These exemptions are already numerous now, and even though some of them are reduced, a long list of what are often opaquely formulated exemptions would remain in force.

Publications and actions on food speculation and MiFID

Friends of the Earth Europe (ed.) e.a.: "Farming Money"

WEED: Factsheet on Food Speculation

WEED: Factsheet on MiFID/MiFIR

Tilburg, Rens van (SOMO): Food Markets in Dutch Dutch Banks and Pension Funds in Agricultural Derivatives Markets

Vander Stichele, Myriam / Rens van Tilburg (SOMO): Feeding the Financial Hype. How excessive financial investments impact agricultural derivatives markets

Avaaz: Email action on Deutsche Bank

Foodwatch: Email action on Deutsche Bank

EU strategy meeting on food speculation and MiFID on 15 September 2012 in Brussels at 11.11.11.

Will the EU be able to decide on a major bank reform in the coming months?

By Myriam Vander Stichele, SOMO

Following the adoption of the new international standards ("Basel III") on capital reserves banks have to hold and in the context of the continuing banking crisis, the EU is currently deciding on how to revise its Capital Requirements Directive ("CRD IV"). After the European Commission had released its proposals in summer last year, the European Parliament and the EU Council of Ministers are now debating their positions on which both sides will start voting and deciding from March 2012 onwards.

While the new provisions would improve the stability of the banking system to a certain extent, critics show how they are insufficient to make banks really safe and sustainable. Remaining possibilities for low capital buffers, insufficient self-risk assessment mechanisms and high levels of borrowing by banks (leverage) will not make banks strong enough in times of further crises. Beyond the technical shortcomings of what is currently on the table, there are still no proposal for a general obligation to use capital in a sustainable, non-speculative way, and to fundamentally eliminate the danger of banks being "too big to fail".

The decision making of a major bank reform is fully under way at the EU's decision making bodies since the end of 2011 and is likely to continue to at least middle 2012. This process should result in an EU legislation that implements the Basel III reforms and other proposals by the Basel Committee on Banking Supervision and agreed by the G20 as explained in Newsletter nr 4. The European Commission has published its legislative proposals (see here) to decrease the risks of bank instability on 20 July as explained in some detail in Newsletter nr 8.

The co-decision making bodies, the European Parliament (EP) and the EU Council of Finance Ministers (ECOFIN), have started their discussions on whether to accept the increase in the quantity and quality of the capital requirements, the buffers of liquid money banks need to hold, the level of borrowing that banks are allowed, and how banks manage and calculate the risks, amongst others when they lend and engage in derivatives markets.

The European Parliament first response
At the EP, MEP Othmar Karas (Austria, Christian Democrat) is the rapporteur who coordinates the changes the EP wishes to introduce compared to the EC proposal. He published his first report on amendments on the Capital Requirements Directive IV (CRD IV) on 14 December 2011 and amendments to the new Capital Requirement Regulation (CRR) on 16 December 2011.

Regarding CRD IV, Karas stresses that:

- Provisions to improve the corporate governance should ensure that there is no conflict of interest, and that renumeration policy and top salaries are aligned with the long term interest of a financial institution.
- The structure of the supervisory boards in banks of the different EU countries should be improved.
- Regulatory arbitrage, i.e. weak implementation of, the Countercyclical Buffer that can be set by national authorities within a range of 0 and 2,5% of risk weighted assets, needs to be avoided.
- Supervisory or other competent authorities must have the power to impose dissuasive and enforceable sanctions, and prevent future violations of banking laws.

In the opinion of Karas according to his draft report on CRR:

- Banking laws in EU countries should adhere to the principle of maximum harmonisation “in order to keep a level playing field” in the EU (a "single rule book"). This means that unequal banks, different in size and activities, should be treated the same and that higher capital requirements should not be allowed. Nevertheless, the new rules should be adapted to the variety of business models and to the special market structure.
- The amount of liquidity to be held should be decided later. In order to make the current observation period meaningful, unitary reporting formats should be established.
- The requirements for management and capitalisation of the counterparty credit risk when engaging in the derivatives markets seem to need to be adapted to the outcome of decisions on the EMIR (see Newsletter nr 7 and nr 8), for instance regarding the authorization and recognition requirements for Central Counterparties by the competent authorities.

Mr Karas noted that the treatment of systemically important financial institutions (SIFIs) still needs to be discussed and integrated in the reform proposals. (For background information, see Newsletter nr 9.)

The EP will further discuss the Karas draft report according to a time schedule which seems unlikely to be achieved:

- 27 February 2012 is the deadline for MEPs in the ECON committee to submit amendments on draft Kara report.
- On 20-22 March 2012, the first discussion on the amendments will take place in the ECON committee and at the end of March 2012 a second debate is expected to take place in the committee.
- On 25 April 2012 at the earliest, the ECON members will vote on the amendments to the Karas report.
- In May and after ECON and the Council have agreed on their (general) positions, the EP and the Council negotiate a compromise text.
- On 12 June 2012 at the earliest, the EP plans to vote on CRD IV/CRR in plenary.

The Finance Ministers Council started the technical discussions
The officials of the EU Council of Ministers of Finance started their discussions on the several different aspects of the CRD IV/CRR proposals in January 2012 in several meetings after general discussions were already held at the end of 2011. The Danish Presidency plans to have the EU Council of Ministers of Finance try to agree on a general approach in March 2012. On 22

June at the earliest the EU Council of Ministers of Finance agrees on the CRD IV/ CRR texts after the EP has voted on them in plenary.

There are still many disagreements among the member states some of whom want to implement higher capital requirements than would be included in the EU regulation. On the other hand, President Sarkozy and Chancellor Merkel have written a letter that they do not want to have to introduce now high capital requirements out of fear that this would cause a credit crunch and lead to unemployment, an argument used by the bank lobby against CRD IV/ CRR proposals and denied by experts. However, the UK and others want to have strict regulation on banks as proposed by the Vickers Commission (see Newsletter nr 8).

Hot debates and very different views
The new banking legislation has already sparked many debates and different views, not in the least because over the last months, the European banks have showed how instable they are due to lack of capital buffers (undercapitalization) and exposure to Greek bonds.

First, there are the fundamental criticisms:

- Increasing capital buffers is not a good tool to stabilize the banks. Banks should use their capital for productive purposes that contribute to GDP and sustainable development, rather than for speculative purposes and trading on financial markets (with their own money). This would stabilize banks in the long term.
- The banks still do not have to legally take into account their public interest functions and their need to finance and invest in environmentally and socially equitable societies, an argument recently raised by the UN.
- The macro economic problems are not being solved by the draft CRD IV/ CRR as they mostly deal with individual bank issues (micro level). More structural reforms are being promised or in the pipeline (e.g. the EU crisis management proposal) but whether these will include splitting retail banking for investment banking or other fundamental reforms remains to be seen. As long as the banks remain too big to fail, the moral hazards still is in place whereby the tax payer has to pay when banks are in trouble.

As regards to more technical problems with CRD IV / CRR, some of the criticisms expressed are:

- The levels of capital buffers (risk weighted capital requirements) are not high enough to prevent banks from failing in times of crisis.
- The risk weighing mechanism and standards should become more transparent and managed more strictly, and not be fixed by regulations e.g. government bonds of OECD countries (including Greece !) should not be officially rated as having 0% risk. They should include better assessments of social and environmental risks and benefits.
- The borrowing rates by banks themselves (leverage) and the transfer of risks of loans (securitization, hedging with derivatives) should be drastically reduced and that should be done before 2018 as opposed to what is currently proposed. At the same time, interest paid on loans should not be tax deductible as this gives an incentive for banks to borrow.
- Off balance sheet activities should be fully taken into account and transparent, or eliminated.
- The accountancy rules for banks and the way profitability of banks is calculated should be drastically overhauled.

For more comments and explanations, see also pages 13 to 16 of the SOMO report The missing dimension - How European financial reforms ignore developing countries and sustainability.

For additional information on some of the comments, see for instance the position paper by Finance Watch To end all crises? Implementing Basel III in the European Union.

Credit Rating Agencies: will the oligopoly be tackled?

By Lydia Prieg, nef

In November of last year, the European Commission (EC) unveiled its draft regulation to reform the credit rating industry and review the regulation already in force since 2009. Whilst many of the EC's initial ideas, such as prohibiting the rating of countries that are undergoing bailouts, have been dropped, many significant changes will be introduced. Most importantly, issuers will be required to rotate the credit rating agency (CRA) that they use on a regular basis.

It is hoped that this will foster competition and encourage new entrants in a market currently dominated by only three companies. However, critics argue that this may result in a lowering of standards, as agencies fiercely compete for business by generously inflating ratings. (Issuers want their debt to be highly rated, as this lowers their cost of funding, and issuers are currently the ones who pay CRAs for ratings). The legislation is expected to come into effect in 2013.

Originally, the European Commission planned to suspend ratings of European countries that are undergoing a bailout. However, this proposal prompted a large outcry from the financial services industry and Britain, as CRAs argue that their rating are 'opinions', and thus banning them would violate freedom of speech and undermine the independence of rating agencies. The industry also argued that such a move would frighten the markets and cause more of a sell-off in government debt than a simple downgrade would.

The Commission justified its position by arguing that it had a responsibility to prevent 'disorder'. For example, ECB officials, such as Christian Noyer, have argued that the agencies rating methodologies appear to be increasingly driven by political rather than economic factors. However, given that S&P and Moody's are based in the US, and, thus, the EC has no power over them, this 'blackout' measure was deemed impractical, and was ultimately abandoned.

In a bid to help improve competition within the ratings agency industry, the EC mandated that issuers must change the rating agency they use on a regular basis: "The credit ratings agency engaged should not be in place for more than three years or for more than a year if it rates more than ten consecutive rated debt instruments of the issuer." Issuers then won't be allowed to return to that rating agency for another four years.

Unsurprisingly, many in the financial services industry are also firmly against this proposal. For example, the Association of Corporate Treasurers (ACT) argued that "Increasing competition at the margin would be healthy, but trying to force issuers to appoint a new player with no track record will not in itself create that competition". Others have argued that "rotation is a form of queuing that will reward market participants regardless of quality and price".

One of the key reasons for the current power of rating agencies will be also addressed: the obligatory and automatic reliance on ratings by financial institutions such as banks and insurance companies. The EC wants "to diminish the impact of 'cliff' effects on financial institutions and markets by reducing reliance on external ratings" and thus wants to clear the respective provisions in laws, guidelines etc. Furthermore, financial institutions will have to undertake an own risk assessment. This would definitely lessen the agencies' power.

Initial plans to block takeovers of small rating agencies by their larger counterparts were also dropped. However, EU investors will now be able to bring civil claims against rating agencies, including for gross negligence. Agencies will also have to give increased notice (24 hours rather than the current 12 hours) to governments in advance of their debt being downgraded. Furthermore, some rules will prevent conflicts of interests. Amongst others, stakeholder with a large share in one CRA (+5%) will not be allowed to have a large share in another.

Other amendments include higher transparency requirements for ratings including the creation of a European Rating Index (EURIX), two obligatory ratings for complex products, and the extension of the rules to rating outlooks. In respect to sovereign ratings, the review intends to have them more often, more transparent and not during the opening times of European exchanges.

Meanwhile, the European Securities and Markets Authority (ESMA) has now begun inspecting the ratings agencies, rather than relying on national regulators to do so, and will release a report on its findings in April 2012. (CRAs that rate European securities now have to register with ESMA, which has the right to refuse any CRA's registration.) ESMA will be assessing the rating agencies from a governance and conflicts of interest perspective. It will also pass some very basic judgements on quality of the methodology deployed to calculate ratings. For example, it may comment on some of the inputs put into the models. ESMA is also in the process of compiling a database that would allow people to compare ratings from different agencies on any given debt product.

All these reforms are a step forward; however, many argue that whilst the 'issuer pays' business model remains, so too will conflicts of interest. The problem is that other business models, such as 'customer pays' or 'exchange pays' present a different set of equally toxic conflicts of interest. In short, there is no easy solution to this mess, and so, perhaps the most important thing for governments and regulators to do, is to continue working on removing references in legislation to CRAs' ratings, and try to ensure that investors are conducting their own credit analysis and so aren't overly dependent on CRA expertise. And, of course, civil society must continue to push for sustainability factors to be taken into account during the credit rating process, as, currently, governments, regulators, CRAs, and investors all utterly ignore this.

Calendar of official events

For more background to the official agenda of European institutions, see the following websites:

The European Commission (EC)

The Economic and Financial Affairs Council (ECOFIN)

The Economics and Monetary Affairs Committee (ECON) of the European Parliament

February

- **13, Brussels (ECON):** First exchange of views on MiFID II
- **21, Brussels (ECOFIN):** meeting
- **22, ??? (G8/G20):** Civil Society Strategy Meeting
- **25-26, Mexico (G20):** Finance Ministers & Central Bank Governors' Meeting
- **27, Brussels (ECON):** planned deadline for amendments on CRD IV report

March

- **1-2, Brussels (EU):** European Council
- **13, Brussels (ECOFIN):** meeting
- **20-21 and 26-27, Brussels (ECON):** planned discussion about CRD IV report amendments
- **26-27, Brussels (ECON):** Presentation of draft report on MiFID II by MEP Ferber, 2nd debate on CRD IV
- **30-31 (ECOFIN):** Informal meeting, possible agreement on a general approach on CRD IV

April

- **20, Mexico (G20):** Finance Ministers & Central Bank Governors' Meeting

- **20-22, Washington (IMF / World Bank):** spring meeting
- **21-26, Doha (Quatar):** UNCTAD XIII
- **24, Brussels (ECON):** Deadline for amendments MiFID II (12 CET)
- **24-25, Brussels (ECON):** planned vote on CRD IV, presentation of draft report on MiFID II by MEP Ferber, 2nd debate on CRD IV

May

- **15, Brussels (ECOFIN):** meeting
- **19-20, Chicago (G8):** heads of state summit
- **30-31, Brussels (ECON):** Discussion on amendments to MiFID II draft report by MEP Ferber
- **EP and Council** negotiate a compromise text on CRD IV

June

- **4-6, Rio (UN):** Rio +20 conference
- **11 (earliest) (EP):** plenary vote on CRD IV
- **18-19, Los Cabos (Mexico) (G20):** heads of state summit
- **18-19, Brussels (ECON):** 2nd discussion on amendments to MiFID II draft report (if needed)
- **22, Brussels (ECOFIN):** meeting, earliest agreement on CRD IV
- **28-29, Brussels (Council):** head of states meeting

July

- **18-19, Brussels (ECON):** vote on MiFID II

September

- **13-14, Mexico (G20):** Finance Ministers & Central Bank Governors' Meeting

October

- 1**2-14, Washington (IMF / World Bank):** autumn meeting

November

- **4-5, Mexico (G20):** Finance Ministers & Central Bank Governors' Meeting

---

FORDFOUNDATION
Working with Visionaries on the Frontlines of Social Change Worldwide

This newsletter has been produced with the financial assistance of the European Union and the Ford Foundation. The contents of this newsletter are the sole responsibility of SOMO and WEED and can under no circumstances be regarded as reflecting the position of the European Union or the Ford Foundation.

This newsletter is produced by SOMO and WEED and is intended for wide circulation to interested parties. We appreciate receiving feedback as well as announcements of research reports, campaign actions, and meetings, which can be sent to m.vander.stichele@somo.nl.

SOMO

weed