Memorandum on the State of the EU Financial Reform Policy

Markus Henn, January 2014

The reform of EU financial market regulation made further progress in 2013 and early 2014, with just a few major issues still fully unaddressed. While some progress has been made on the latest decisions, they have also been watered down in the law, so that important reforms such as the Financial Transaction Tax or a proper banking regulation have still not been achieved. Without the proper regulation and taxation of all financial actors and a sustainable debt workout, products, trading places and financial markets remain fragile, and the euro zone crisis will not be solved.

1. Banking reforms lack teeth
The final reform of the Capital Requirements Directive and Regulation (CRD IV/CRR) was clearly insufficient. While a stronger regulation does not seem politically feasible at the moment, in the long run reform will need to go further. The situation has been further worsened by the recent decision of the Basel Committee on Banking Supervision to water down the leverage ratio and allow banks to calculate the ratio down significantly. The new proposal by the European Commission on the separation of banks and/or their businesses is also far from sufficient.

■ The EU still needs to implement a strong capital requirements regime beyond Basel III. Some European states such as Switzerland and the UK will go far beyond the minimum standards for large banks. The EU should follow this example and require at least 20 per cent capital for large banks.

■ The EU needs to implement a strict leverage ratio. The EU must not follow the Basel Committee decision to have a weak ratio. The financial and the sovereign crises have shown that there is no such thing as a non-risk financial instrument. The EU should also abandon the internal measurements of risks by the banks.

■ Banking activities should meet strong sustainability requirements. Any loan or other financial activity must undergo a sustainability assessment.

■ The EU should prevent risky trading by prohibiting banks trading on their own accounts. If this is not achievable, a strict separation of retail and proprietary businesses should be put in place.

2. Banking union – difficult solution
The EU finance ministers made a proposal for a Banking Union in October 2013 to regain political control over the finance sector in the euro zone. It includes

a) joint supervision,

b) a common deposit guarantee scheme and
c) a joint single resolution mechanism with a clear cascade of responsibility for losses.

The full union shall start in 2018, but the supervision shall already begin in November 2014. Even though some of the elements in the proposal are correct, it has some important shortcomings. For example, the ECB will control supervision even though it would have been better if an independent institution had taken on this task. The ECB is hardly accessible for democratic control and thus will not take many of the concerns regarding EU crisis policy into account.

It is also improbable that the Union will work, given the deeper structural problems of the European Union, the lack of real European solidarity mechanisms and the willingness to form these. It is also far from clear whether the EU member states will reach an agreement.

3. Shadow banking: getting the money out of the dark
Shadow banking, in the sense of all bank-like activities not being fully covered by banking regulations, was also high on the political agenda in 2013, with the Financial Stability Board (FSB) releasing several reports ahead of the G20 St. Petersburg summit in September 2013 and the G20 deciding on a roadmap on
shadow banks with their leaders' declaration. In September 2013, the European Union proposed a law to regulate money market funds as one example of shadow banks.

To ensure that the shadow banking sector does not continue to threaten the integrity and stability of the financial system, the following measures need to be put into effect as soon as possible:

- More transparency and better data on shadow banking entities is needed.
- Spill-over effects between the regular banking system and the shadow banking system must be mitigated. One element of this is that lending collateral must be restricted.
- The ownership of any security and derivative needs to be clearly determined.
- All financial actors need to face the same capital and liquidity requirements.
- Securitisation must be limited to half of an asset. This should only be allowed with the prior and informed consent of all stakeholders on the underlying assets. Re-securitisation should be prohibited. The Capital Requirements Directive, with its 5% limitation (10% in Germany), is much too weak.
- Limits on asset concentration and investments in illiquid assets are needed.

4. MiFID does not sufficiently tackle commodity and high-speed trading

The review of the Markets in Financial Instruments Directive and Regulation (MiFID/MiFIR) is not merely an important outstanding reform, it is particularly vital for developing countries, due to its regulation of commodity and food speculation. On 14 January 2014, after two and a half years of negotiations and almost four years of discussions, a political compromise was agreed in the Triilogue, which will be formally decided by the Parliament and the Council in the next months.

- Regarding high frequency trading, the EP proposal to introduce a minimum holding period of half a second for all offers did not survive. However, it can be seen as a success that at least minimum tick sizes were finally introduced, which was not envisaged by the Council in its initial position.
- Regarding commodity and food speculation, the outcome is insofar positive as it even goes beyond the initial positions of the Parliament and the Council. Most importantly, position limits are clearly foreseen, also including relevant over-the-counter markets. However, the exact scale of the limits will not be decided at the EU level, but by member states’ authorities. Furthermore, they will only be based on net positions and are not said to address excessive speculation. In addition to these disappointments, the bigger problem is that prohibitions for financial products betting on commodity prices were not approved, even though in the Parliament, at least, there was some support for them.
- Regarding the market infrastructure, the EP and the Council currently agree on introducing a new trading venue called the “organised trading facility” (OTF). The OTF is a second, lightly-regulated trading venue, which is intended to get some over-the-counter trading back into the marketplace – but it will probably also lead to further market fragmentation, as was the case with the “multilateral trading facility” introduced in 2007 by MiFID. This fragmentation will make the markets even more opaque and prone to abuse and crises. Therefore, the reform should have reduced the number of market types, with only one strongly regulated type for all securities and derivatives.

5. Tackling tax evasion and money laundering is too slow

Tax evasion and money laundering where top issues of both the G20 and the G8 in 2013. After the tax annex to the G20 leaders’ declaration at the St. Petersburg summit in 2013, the implementation work by the OECD will last for the next few years. The “base erosion and profit shifting” (BEPS) action plan on corporate tax avoidance will be worked on until the end of 2015. The European Commission proposed a revision of its most important law on corporate taxation, the parent-subsidiary directive, and the heads of state also discussed the issue at various occasions.

- Regarding transparency for individual taxpayers, the G20 now have accepted the automatic exchange of information as the future standard. At the last OECD global forum meeting, this decision was initially implemented, with a group of 38 states even making a special commitment. However, at the EU summits, real progress, e.g. on the European Savings Tax Directive, has still been halted by Luxembourg and Austria, countries which refuse to give up their anonymous withholding tax. Meanwhile, the US Foreign Account Tax Compliance Act (FATCA), which requires all US banks and other financial companies to disclose relevant US taxpayer data, has triggered intensive negotiations over bilateral tax agreements with mutual automatic information exchange. While the whole process is promising, it needs to be accelerated and the EU tax havens must be closed down.
- The situation on corporate transparency is mixed: while banks (through the Capital Requirements Directive) and commodity/
companies (through the Accounting Directive) will have to report, in general companies will not. The second attempt to introduce a comprehensive reporting in the EU failed in December 2013. To tackle tax evasion, strong country-by-country reporting requirements are a necessary prerequisite that need to be implemented. Therefore, a new EU law-making process should start as soon as possible.

- Regarding corporate tax dodging and the implementation of the G20/OECD action plan, the EU needs to play a leading and progressive role. Tax avoidance is one of the reasons why the EU crisis has been hard to solve, as, for example, the relocation of Greece’s biggest company Coca-Cola Hellas to Switzerland has demonstrated. The European Commission has at least proposed a revision of the most important corporate tax law, the Parent Subsidiary Directive. The proposal is intended to prevent cases in which a corporation ends up being charged no tax at all. The member states should now pick up the ball and come to a swift conclusion on the Commission’s proposal.

- The on-going reform of the anti-money laundering directive is a welcome opportunity to tackle criminal activities, corruption and tax evasion at the same time. In its committee session in mid-February, the European Parliament has the opportunity to introduce public registers for companies, trusts and foundations indicating the beneficial ownership.


Negotiations in the framework of the Enhanced Cooperation Procedure (ECP), which started in 2012, are still on-going. While a political agreement is still likely, there have been various attempts by the financial lobby and its political allies to water down the proposal. Most worrisome have been moves within the French government against the FTT, even though the tax was still supported finally. The new German government put a strong commitment to the text into its coalition agreement. The following features must be kept in the final FTT law:

- No exemptions for pension funds, market makers and repos

As several studies show, both ordinary pensions and prudential funds are not being negatively affected by the FTT. On the contrary, this creates an incentive for prudent behaviour, and thus contributes to both the stability of pensions and larger long-term benefits. If some ordinary pensioners should nevertheless be negatively affected, the problem could be solved through compensation in the normal income tax reduction mechanism.

Also, market making should not be exempted. Market makers are using the mechanism to make huge profits by injecting over-liquidity into the markets. It would be good for financial stability if over-liquidity were reduced to the level necessary for normal market functioning. The FTT can contribute to this end.

Finally, exemptions for repos, as proposed in 2013 by the financial lobby and some others, would also go in the right direction. As a study by Professor Schulmeister shows, repos should be covered.

- No FTT without a broad tax base

A broad tax base of shares, bonds and derivatives is fundamental to the success of the FTT. Fortunately, the new German government has committed to such a broad base. If derivatives were exempted, tax income would be much smaller, and the financial industry would use derivatives to avoid taxation of shares and bonds as well.

A two-step approach – first shares and bonds, and, at a later stage, derivatives – is also wrong. As the British example shows, taxing shares alone does not prevent the build-up of an unsustainable financial market. The FTT has to be implemented with the broad tax base proposed by the Commission from the very start.