Memorandum on the State of the EU Financial Reform Policy

Peter Wahl / Markus Henn, March 2013

The reform of EU financial market regulation since the financial crisis is still ongoing, five years after the crisis erupted. While some reforms have already been decided and one cannot say that nothing has taken place, important reforms are still being negotiated. In any case, the reforms are far too timid to prevent the next crisis. Without the proper regulation and taxation of all financial actors, products and trading places, the next crisis is only a matter of time, and the ongoing Euro-zone crisis will not be solved. In the following chapters, the most important remaining reforms are discussed.

1. Banking reforms lack teeth
The reform of the capital requirements directive and regulation (CRD IV/CRR), implementing the international Basel III standard, should actually have already been completed by 1 January 2013. However, the reform is still stuck in trilogue negotiations between the Council, the European Parliament (EP) and the European Commission. In March 2013, there was a compromise, at least on some contentious issues. However, several important questions remain unsolved. To make banking sustainable, the reform needs to achieve the following:

■ The EU needs to implement a strong capital requirements regime. The Basel III standard is not sufficient. Thus 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. With Basel II, the weighting of assets for the calculation of capital requirements became common. But the financial and the sovereign crises have shown that there is no such thing as a non-risk financial instrument. It is now time to go back to former rules, with the basic idea that any financial instrument can cause trouble and thus needs capital. The leverage ratio should not be higher than ten. It would even be reasonable to renounce the weighting of assets altogether, which would make the leverage ratio the same as the capital requirements.

■ Banking activities should meet strong sustainability requirements. Any loan or other financial activity must undergo a sustainability assessment. The equator principles of the World Bank could be a starting point, but the standards should be higher in the end.

2. Make financial instruments serve society and stop speculation
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. The EP took its position in October 2012, but the Finance Ministries have not been able to finalise negotiations so far. Even though the Irish Presidency aims to finalise the Council negotiations by June, many observers expect it to be in autumn. Hopefully, final negotiations will reach a final deal before 2014, because otherwise this process might be hampered by the next EP election. Some points should be duly addressed in the MiFID:

■ Regarding high frequency trading, the EP has taken a remarkable position, calling for fees against cancellation, the cancellation of certain types of privileged market access and minimum holding periods for offers. However, the Council has not taken regulations like this into its position so far. The Council should follow the EP in its position – but actually, should go even further and prohibit high frequency trading, as it is not needed.

■ Regarding commodity and food speculation, both the EP and the Council have taken at least some measures into their positions. Both are calling for position limits on commodity derivatives, which should stop derivatives speculation on food prices. But the details are still unsat-
isfactory. As long as it is not ensured that over-the-counter trading and all trading months are covered, the limits will not be strong enough. But beyond this, even certain prohibitions for products related to commodity prices should be prohibited for retail consumers.

■ Regarding the market infrastructure, the EP and the Council currently seem to agree on introducing a new “organised trading facility” (OTF), even though the EP is calling for a more restrictive approach. However, the OTF will probably lead to further market fragmentation, as was the case with the first MiFID and the “multilateral trading facility”. This fragmentation will make the markets even more opaque and prone to abuse and crises. Therefore, the reform should reduce the number of market types, with only one strongly regulated type for all securities and derivatives.

3. Tackling tax evasion and money laundering

With “Offshore Leaks” and the G20/OECD efforts on corporate taxation (e.g. the “base erosion and profit shifting” project), the debate on tackling tax evasion has gained new momentum. Previously, the European Commission had already begun to ramp up its efforts, with other reforms to promote transparency proceeding for an even longer time.

■ Regarding transparency, the reforms have recently been concluded. The results are mixed: while in the banking reform (Capital Requirements Directive) some strong requirements for country-by-country reporting of important financial data seem to have been established, the same requirements are at risk for companies (Accounting Directive). At least some requirements for commodity and forestry companies on payments to governments (Transparency Directive) some strong requirements for an even longer time.

■ Regarding corporate tax dodging, the Commission has now proposed some measures that openly attempt to tackle double non-taxation. This is a welcome change, as previously, the Commission only focused on preventing double taxation. The measures include amendments to the Interest and Royalties Directive and the Parent Subsidiary Directive, both placing the exemption of the respective financial flows from taxation under the condition that it will not result in double non-taxation. The amendments would be a good step forward and should both be made compulsory for all EU member states to prevent tax competition.

■ Regarding individual tax evasion, the EU urgently needs to bring forward the automatic exchange of information between tax authorities. It therefore should extend the Savings Tax Directive to all capital income and to moral persons. And it needs to force Luxemburg and Austria to join the exchange instead of anonymously withholding taxes, as is the case now. Furthermore, the EU needs to extend its international exchange regime by implementing a law similar to the US Foreign Account Tax Compliance Act (FATCA), which requires all US banks and other financial companies to disclose relevant US taxpayer data.

■ The ongoing reform of the anti-money laundering directive is a welcome opportunity to tackle criminal activities, corruption and tax evasion at the same time. In particular, by setting up comprehensive public registers for companies, trusts and foundations indicating the beneficial ownership, the EU could very effectively deter any money laundering.

4. Securing final success for the Financial Transaction Tax

The start of the Enhanced Cooperation Procedure (ECP) towards the establishment of a European Financial Transaction Tax (FTT), begun in 2012, is a huge step forward as well as a big success for all proponents of the tax. However, final success still has to be secured. As the ECP also allows for participation in the negotiations of those countries that do not participate in the FTT, some of them use this opportunity to throw sand in the wheels. The Irish Presidency behaves in a partial way: Luxemburg and the UK try to place pressure on their partners by threatening legal complaints, and others push for exemptions. There is the risk of considerably water down the Commission’s draft.

■ No exemptions for pension funds and market makers

Hence, the proposal to exempt pension funds has to be rejected. As several studies show, including one by a leading German economic institute (DIW), both ordinary pensions and prudential funds are not 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 nec-
2. Financial transaction tax: necessary for normal market functioning. The FTT can contribute to this end.

**No FTT without a broad tax base**

A broad tax base of shares, bonds and derivatives is fundamental to the success of the FTT. 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. The FTT would be turned into a paper tiger.

Therefore, a two-step approach – first shares and bonds, and, at a later stage, derivatives – is wrong. As the results of the unilateral French FTT, which excludes derivatives, show, this tax remains far below what could actually be achieved by a well-designed tax. Should the first step be implemented, its results would – as a self-fulfilling prophecy – be used to prevent the second step of implementation. This is why the FTT has to be implemented from the very start with the broad tax base proposed by the Commission.

5. Banking union – only a starter

The establishment of a Banking Union could be a step in the right direction to regain political control over the finance sector in the Euro-zone. However, establishing supervision is not enough, as shown by the experience with the European Banking Authority (EBA), which did not meet expectations. Therefore, the Banking Union has to be embedded in a set of other measures, particularly:

- A common resolution mechanism,
- A common and credible deposit guarantee scheme, and
- Reform of the banking structure that reduces the complexity and size of all big banks to an extent that they are no longer too big to fail, but manageable enough to be effectively controlled and small enough to fail.

These elements have to be implemented in a package, together with supervision. Otherwise, supervision will remain a paper tiger. But certain requirements also have to be fulfilled for the new supervisory scheme. In particular, the connection of the new body to the ECB constitutes a challenge:

- There has to be a strict separation between the ECB and the new institution.
- The leadership and the personnel of the new institution have to be separate from the ECB.

- The concept of “independence”, as it has been established for the ECB, cannot be applied to the new authority. Instead, it must be made accountable to a democratically elected body, i.e. the European Parliament.

- The new institution has to be provided with sufficient human and financial resources to fulfil its mandate.

- The legal competence has to be strong enough that its decisions can be implemented, if necessary, even against the will of a national government.

6. Shadow banking: getting the money out of the dark

Shadow banking, in the sense of all bank-like activities not fully covered by banking regulations, has been high on the political agenda since 2012. The Financial Stability Board (FSB) published a monitoring report in November 2012 indicating that the shadow banking sector amounted to $67 trillion in assets at the end of 2011. Rightfully, the Commission and the EP pointed to the danger of systemic risks caused by the nature and complexity of shadow banking, as well as to the problems inherent to weak regulatory regimes. The EP has also stated that there is excessive interconnectedness between the banking sector and shadow banking entities.

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 are 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. It should be only allowed with the prior and informed consent of all stakeholders of the underlying assets. Resecuritisation should be prohibited.
- Limits on asset concentration and investments in illiquid assets are needed.