



## EU Policy towards Financial Market Regulation

### I. Introduction

Since Spring 2009, the previously steep decline in EU output has been decelerating. Yet this does not mean that the crisis is over – the world economy is still in the middle of the most serious financial crisis and the real economy in Europe is facing the deepest recession in 60 years. At this moment where policy makers and economic forecasters are identifying “green shoots”, pointing to an earlier recovery than envisaged a few months ago, the unprecedented *rise in unemployment* rates is only *slowing down*, but far from stabilising or even falling. A further deterioration in employment and labour market conditions lies still ahead of us, and, according to the latest OECD and IMF forecasts, the pace of the recovery is likely to be modest for some time to come. High and rising unemployment, stagnant or falling labour income, coupled with ample spare capacity and structural corrections in member states is keeping aggregate demand depressed. Workers and their families are paying a triple bill for a crisis they have no responsibility for: as job holders who are facing unemployment; as taxpayers who are facing higher taxes for less public sector services; and as parents who are facing less quality in education and training for their children.

The pre-crisis concept that profits in the financial sector could grow at double digit rates while overall economic growth remained in the lower single digit range, has proven unsustainable. While it is true that financial markets have stabilized, this is largely because of the huge bail-out programmes that governments have put in place since last autumn. Banking system losses have effectively been nationalized i.e. socialised, whereas bank executives and shareholders continue to reap the benefits of the global casino with no participation in the cost of the economic catastrophe that Europe and the rest of the world are now experiencing. The financial sector lobbies appear stronger than ever at a time of enormous losses in general welfare. In light of this, the relatively moderate policy recommendations of the de Larosière Group, published on 25 February and broadly adopted by the Commission on 27 May, risk further weakening in the legislative process ahead.

The central lesson from the allegedly ‘unforeseeable shockwave’ of Lehman Brothers’ meltdown must be for European policy makers to limit the size and weight of financial institutions such as they can no longer become “too big to fail”, requiring further bail-outs and recapitalisation at the expense of taxpayers. Yet this is exactly what has happened over the past 12 months. Secondly, there are historical lessons that policy makers must draw from the crisis of the 1930’s and the Japanese experience of the 1990’s: the pace of return to previous levels of wealth will remain moderate as long as the casino remains open and financial sector damage unrepaired. Financial recovery and real recovery go together so that, as policy in Sweden in the 1990’s has shown, potential growth be restored to pre-crisis levels.

Important financial centres are lobbying massively to minimise any EU initiatives to introduce regulation, notably on hedge funds and private equity. There is a

clear need to campaign for a robust regulation at international and EU level. The ETUC supports the campaign "Europeans for financial reform" organised by the Global Progressive Forum. Co-founders of the campaign are PES, S&D Group, ITUC, UNI, Solidar and FEPS. Themes of the campaign are: (1) New rules for the financial system, (2) restoring publicly accountable authority over global finances, (3) control executive and shareholders remuneration and decent salaries for workers (4) protect public finances, (5) protect consumers against toxic financial products and (6) bring banks back to basics. The campaign has been launched on 21 September 2009.

A first background document on EU policy towards financial market regulation was discussed at the meeting of the ETUC Executive Committee on 8 July 2009. This resolution puts forward concrete proposals and sets out the ETUC policy views on the necessary regulatory measures to prevent further financial crises to occur and recent legislative proposals of the Commission in that respect. It draws on cooperation with affiliates, UNI Europa, ITUC and TUAC, and on monitoring the debate on financial market regulation at the level of the G20.

## **II. Fighting the crisis - Policies for a sustainable financial system**

For the ETUC, the provision of finance is a global public good and has many features of a service of general interest. A new and sustainable growth model must reassign a commensurate role for finance in society and the economy. Responsible financial governance needs government and a reversal of the "quiet coup" (Simon Johnson, former IMF chief economist) through which finance has accrued too much economic and political power. Trade unions expect governments to be accountable to workers and their families in solving the crisis. They must take their role back from the self-referential elitist networks of financial institutions and state bureaucracies who over the past 20 years have successfully imposed their neo-liberal agenda of deregulation and privatisation.

Urgent action at EU and the wider international level in the framework of the G20 is needed to ensure that the national, European and global regulatory architecture provides for a banking system that delivers stable and cost-effective financing for the real economy, enhancing growth, stabilising macro-economic volatility, and allocating finance to socially beneficial use. A robust regulation of financial markets must therefore cover:

- sufficient enforcement powers of supervisory authorities
- regulation of hedge funds and private equity groups,
- regulation of rating agencies,
- abolishment of tax and regulatory havens,
- taxation of financial transactions, at least at European level,
- sufficient capital reserves requirements and standards,

- remuneration and bonuses schemes which reflect long term and sustainable performance,
- protection of working families against predatory lending and miss-selling of risky financial instruments,
- encourage the diversity of the financial service sector through a functional separation of institutions and
- democratisation of finance through high standards of social dialogue and the involvement of trade unions at all levels.

However re-regulating finance will not be enough to restore social justice. Those who are responsible for the crisis through irresponsible collective behaviour will have to bear a good part of the burden that our societies will have to carry in the future. The ETUC demands the application of the 'polluter pays' principle to financial markets through means of a Financial Transaction Tax (FTT) at EU level and beyond.

A carefully designed tax on financial transactions with a low marginal rate would make these more expensive and would thereby dampen those transactions and contribute to a stabilisation of the prices of shares, commodities and exchange rates. Speculative trading would be the hardest hit, with short-term investors paying higher taxes due to their higher transaction frequency, without penalising sensible real economy related transactions. At the same time, significant tax revenue could be generated, which could be used to support social policy at European level in the aftermath of the crisis.

Taxes on financial transactions in individual European countries are not a novelty (e.g. "stamp duty" in the UK), nor are harmonised taxes at European level: Value Added Tax or taxes on savings are examples for effectively introduced regulations at the European level. A Europe-wide tax on financial transactions would be applicable to all traders and not to countries and as such independent of the location of prominent financial centres.

The Pittsburgh G20 Summit mandated the IMF to prepare for the next summit a report on instruments to make the financial industry "a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system" (para 16 of the Leaders Declaration), which the advocating governments regard as an important step towards a global FTT. Notwithstanding the global debate, the European Union, as an important economic entity, is perfectly able to introduce such a tax on its own.

Liberalisation of financial markets and modern communication technologies have made it considerably easier for individuals and corporations, including from the financial sector, to go "off-shore" to evade taxes legally due. This, combined with the lack of transparency and effective cooperation between tax administrations, has made offshore non-compliance easier. The ETUC is firmly opposed to tax havens and 'competitive tax regimes'. Good governance in the field of taxation must be the rule.

The ETUC fully endorses the global trade unions' five point strategy to deal with the crisis and beyond to build a fairer and more sustainable world economy for future generations. The strategy has been put forward to the G20 group and calls on policy makers to:

- implement a coordinated international recovery and sustainable growth plan.
- make the "green economy" investments that can move the world economy onto a low-carbon growth path,
- establish new rules to control global finance,
- build effective and accountable global economic governance,
- make the world economy a fairer place to work and live in.

*(Global Union Statement to the London G20 Summit)*

Since the inception of the G20 summits in November 2008, considerable steps have been made at that level on building a system of effective global economic governance. Yet as the leaders in Pittsburgh stated themselves, far more needs to be done to protect jobs, consumers, depositors, and investors in the real economy against abusive market practices of finance, and help ensure the world does not face a crisis of the scope we have seen.

While the immediate and internationally coordinated crisis management by governments has proven successful in avoiding the worst, the same cannot be said of governments' resolve to tackle the structural flaws that have led to the crisis. Among many European policy makers, the origins of the crisis are regarded as if they had come over Europe from a distant planet or as an unforeseeable natural disaster. However global and intra-European macro-economic imbalances and ensuing capital flows, massive shifts in income distribution within and between countries over the last two decades, the leveraging of the world economy by many non-banking institutions on the periphery of prudential regulation and the explosion of credit derivative markets, as well as regulatory arbitrage appear among the root causes of the crisis.

The ETUC therefore insists that implementation of the commitments made at the G20 meetings since last year must be sped up on a number of key issues, including regulation of hedge funds, private equity firms and other private pools of capital, derivatives and securitised products. The scandal of bankers and traders' multi-billion bonuses that erupted during the summer 2009 illustrates the need for urgent action that goes well beyond the commitments made in Pittsburgh.

The ETUC expects of governments to implement high quality standards that ensure a global level playing field for a new financial system and eliminate regulatory arbitrage. The neo-liberal creed of fundamental financial market efficiency must no longer prevail. Europe must go ahead in internationally coordinating effective reform and rebuild prosperity for all through coherent economic, social, and environmental strategies that put people first.

### **III. Re-regulating financial markets**

#### **1. Macro- and micro-prudential supervision and control**

On 23 September, the Commission adopted a package of legislative proposals covering macro and micro prudential supervision and control. This draws on the Communication of 27 May 2009 on Financial Supervision in the EU, describing in detail how these recommendations could be put into effect (COM 2009, 252 final), and proposing two pillars of reforms to the current architecture of financial services committees. A first discussion of this took place in ECOFIN and the European Council in June, demanding that the new framework would be fully in place in the course of 2010, and a second discussion in ECOFIN on 1-2 October. The package contains the following regulations:

- Proposal for a regulation on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB), on which a political agreement is expected to be reached until the end of 2009 under Swedish presidency;
- Proposal for a decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board;
- Proposal for a regulation establishing a European Banking Authority (EBA);
- Proposal for a regulation establishing a European Insurance and Occupational Pensions Authority (EIOPA);
- Proposal for a regulation establishing a European Securities and Markets Authority (ESMA)

At the core of this stands the creation of a European Systemic Risk Board (ESRB) for the surveillance of systemic risk at macro level, reporting to the ECOFIN Council and the European Parliament, and the establishment of a European System of Financial Supervisors (ESFS) for the supervision of financial institution at micro (company) level, composed of both national and EU level supervisors for banks, insurance, occupational pensions and securities. According to the Commission's plan, oversight of specific financial institutions should remain in the hands of national watchdogs, but three new EU authorities will be set up to better coordinate supervision of both national and around 40 cross-border banks and insurance companies which alone hold 70 per cent of EU deposits. The three authorities will be a European Banking Authority, a European Insurance and Occupational Pensions Authority and a European Securities Authority, replacing and renaming the existing EU committees (but not national authorities) supervising EU banks, insurances and securities (CEBS, CEIOPS and CESR).

ESRB and ESFS should cooperate closely and interact in exchanging information between the micro level and macro analysis. Their main functions would be to:

- develop a single set of harmonized rules,
- improve the supervision of cross border institutions,
- help settle disputes between national supervisors,
- have full supervisory power over certain entities such as credit rating agencies and pan European clearing systems,
- collect relevant micro prudential information from national authorities and
- improve co-ordination in a crisis

The ETUC strongly welcomes the provision in article 22 of all three regulations concerning the ESFS to establish stakeholder groups for EBA, EIOPA and ESMA. Employee representatives are specifically mentioned to take part in these, next to consumers and other groups of stakeholders. Stakeholder groups will be given consultative rights on matters relating to technical standards in Community law (art. 7) and guidelines and recommendations to national supervisory authorities or financial institutions (art. 8). These legal provisions mark a positive step compared to the Communication of May and constitute progress towards more transparency in a formerly closed community of supervisors.

However, more needs to be done to achieve real workers' participation in systemically important areas of finance. The central role of employees in the finance sector for the reform of the finance sector should be more seriously taken into account. The ETUC supports the suggestion of UNI Europa Finance that the top-down approach should be complemented by a bottom-up approach that puts the factor "employees" into equation of financial regulation, supervision and risk management. Supervision and control must not solely be left to the closed community of elitist financial networks, economic 'experts' and state bureaucracies. Those affected groups who bear the economic and social risks of the crisis with no responsibility for it whatsoever - trade unions and other civil society organisations, in particular women's organisations, must get involved. The ETUC demands a seat in the European Systemic Risk Board.

The Commission proposal has several other important flaws. The ESFS authorities would be based at three different locations - London, Paris and Frankfurt. Moreover, in ruling out the ambitious idea of establishing a single EU supervisor with binding powers, the EU supervisory landscape would remain fragmented across member states and the EU as well as across functions. Furthermore, as experience e.g. with HRE's foreign subsidiaries in Ireland has shown, national authorities do not have the ability to foresee and to handle a cross border financial crisis efficiently and in a coordinated manner. While in the event of disputes between national agencies, the three ESFS agencies shall be given the power to impose binding agreements; this does however not apply to any dispute that might have fiscal consequences. This watering down is the result of UK opposition and severely impacts the crisis resolution and co-ordination powers of these institutions.

While the ESRB will not have any legally binding powers, the Commission expects it to exert influence through the quality of its analysis and by the virtue of its high-powered membership. The ETUC would prefer clear enforcement power to the ESRB over the failed model of self-regulation of finance.

The ETUC firmly believes that Europe can not limit itself to coordinate national financial markets' regulatory authorities. The regulatory framework as well as scope and quality of regulation must be strengthened at European level. Europe needs a transparent and publicly accountable Financial Supervisory Authority under the auspices of the ECB, with effective executive powers over banks, insurance companies and other financial institutions.

It is a positive step forward that the new European authorities will be able to coordinate and intervene, however in the likely event of conflict between national authorities on burden sharing this may turn out insufficient. A mechanism of burden sharing between national authorities must be put in place; the Directive would have to clarify this. As the new European financial supervisory framework is currently conceived, both ESRB and, more importantly, ESFS may at best function as early warning systems. Until the establishment of a single EU supervisor, the European Supervisory authorities must be given binding decision-making powers over national supervisors if they fail to meet their obligations deriving from European law.

In the current situation, the most important task of an EU Financial Supervisory Authority would be to undertake EU wide stress tests through a generalised and non-discriminatory insight in the books of banks, insurances and other financial institutions. This would pursue the objective to restructure the financial sector so as to put it back on a healthy basis. In the IMF Global Financial Stability Report of October 2009, estimates of global toxic assets were boosted to \$ 3400 billion of which \$ 814 billion originate in eurozone and \$ 604 in UK banks. This compares to \$ 463 billion that banks and insurance companies in Europe have so far acknowledged in write downs. More than half of European banks' expected losses have still not been recognised, of which € 330 billion will incur by the end of 2010. Many banks in the EU are *de facto* insolvent and most of them need to clean-up their balance sheets. The reason why not all member states have undertaken stress tests of their financial institutions (or made public parts of their results) is simple: for fear of resuscitating uncertainty provoking another collapse in confidence, but not least also for fear of competitive disadvantage vis-à-vis other countries.

Open bank insolvency has been avoided largely by transferring toxic assets to bad banks or government entities, yet this has not led to the desired results as banks are still not lending money as they should. Government subsidies for private bad banks, or public bad banks to clean up private banks' toxic assets, will result in high cost for workers and taxpayers for transferring money to troubled banks. All subsidies and transfers should be transparent, and public/private bad banks are not. Despite of enormous liquidity provisions to banks, credit conditions have worsened considerably, in particular for SMEs, and in some member countries, industry has issued serious warnings against a possible credit crunch. At this juncture and as the case of Japan in the 1990's has shown, the financial and economic crises risk nurturing each other pushing the economy into a double-dip recession. The resolution of the banking crisis is

therefore an urgent prerequisite for pulling the economy out of recession. Instead of relying as it does on a voluntary approach, governments across the EU should force assisted banks to cooperate by opening their books, and should take equity stakes in banks as a means of financing restructuring through debt for equity swaps, effectively putting insolvent banks under public receivership or, as some might say, nationalisation. Again, the ETUC believes that these principles would best be agreed on at EU rather than national level.

In this context it is significant to note that there is neither a common definition of systemically important financial institutions nor plans for a special regulatory regime for them in the EU. The ETUC demands the EU to draft regulation on a consistent and credible system of burden sharing, in particular through an EU wide bank deposit guarantee reinsurance fund, which should be financed by, and be mandatory for all cross-border financial institutions and would have to step in when emergency rescue is required.

Investment and commercial banking must be clearly separated and the size of financial institutions limited through the use of anti-trust or competition legislation. Financial sector reform in the field of *systemically important financial institutions* must not be restricted to banks but encompass any institution, including hedge funds and non bank finance companies (such as finance subsidiaries of industrial firms) as being systemically significant to leave no loopholes in a strict regulatory regime whether it is otherwise regulated or not. The reform must apply regulatory restrictions across the corporate structure including holding and subsidiary companies. It is therefore of utmost importance to provide for qualifications in the upcoming legislative process that conduits and special investment vehicles are covered by the regulations, which currently they are not.

At international level, the ETUC expects from the Commission and member states to play a leading role in constructing a new global, transparent and accountable financial architecture, involving the Financial Stability Board, the G 20, the IMF and the World Bank as well as the ILO. On both the European as well as the international level, social partners have to be closely involved. A reformed rather than just renamed Financial Stability Board (FSB) must open up to dialogue with those stakeholders who are directly impacted by the financial system – notably workers, including workers in the financial sector, and trade unions – who can bring a “bottom up” approach to financial reform in the construction of a new global financial architecture so as to make it transparent and ensure that a crisis on this scale never happens again.

## **2. Regulation of hedge funds and private equity**

On 30 April 2009, the Commission adopted the Alternative Investment Fund Managers Directive (AIFM (COM 2009, 207 final)), a mild set of rules for hedge funds and private equity firms, requiring mandatory registration and disclosure of their activities to regulators, while at the same time easing their access to European markets. The obligations are not applied to the funds themselves, but only to their managers. The proposal has several important flaws and spares hedge funds and private equity from tight regulation. It is also much weaker

than the European Parliament has asked for with cross-party majority in two resolutions in September 2008. Since many alternative investment funds are not domiciled in the EU and others will be able to become non-EU domiciled in order to avoid the directive, the proposal creates an immediate potential loophole.

A major problem of the proposed directive is that it focuses on issues relating to macro-prudential risks and does not address the risks to the real economy caused by the operation of alternative investment funds. This is a serious problem; in the current economic climate, private equity portfolio companies' high debt levels, inherited from the highly leverage deals attached to their purchases, make them especially vulnerable; according to Standard&Poors, more than half of corporate defaults in the current year involved former or current private equity portfolio companies. It is therefore more than surprising that the directive contains no provisions to restrict leverage levels for future transactions. Furthermore, the draft doesn't address the concerns that have been raised by ETUC and affiliates several times about the impact of private equity buyouts on employment conditions and levels for workers in portfolio companies. The resolution of the European Parliament recommended extending the protections of the Acquired Rights Directive to takeovers by share transfers, which would include private equity buyouts. Instead of establishing effective and sufficient rules, the Commission gives a helping hand to this under pressure of a € 2 trillion industry. ETUC and affiliates will have to work hard to get significant improvements during the legislative process. The Parliament has appointed Jean-Paul Gauzès as rapporteur and a draft report is announced for end of October followed by a first exchange at the Economic Committee on 6 November 2009.

Although the draft directive does indeed list some of the risks that are associated with AIF's, it fails to address them comprehensively, in particular with regard to highly leveraged hedge funds (HF) and funds of funds. One might argue that proper regulation of capital requirements for banks would be sufficient to prevent excessive lending to HF by the banks' own prime broker institutions, however the crisis has shown that the limits between banking, brokerage and AIF's have become increasingly blurred. Financial institutions must be functionally separated, which in turn requires specific regulation of AIF's.

The ETUC insists that regulation of HF and PE must avoid the creation of loopholes: it needs to be "all encompassing" and, as a principle, must not have any 'de minimis' exemptions. The ETUC demands that the threshold of AIF covered by the Directive, currently at €100 million for HF and €500 million for PE funds, is set to Zero.

Both fund managers and funds need to be covered, in particular as offshore funds are most often used for tax and regulatory arbitrage reasons. The right territorial criterion to use when determining which fund manager or fund should be registered is not only the location of the entity (as it may easily be relocated offshore) but the location of the final investors.

The ETUC demands the following improvements to the current AIFM to more comprehensively address the associated risks of AIF's and the purpose for this regulation:

- Addressing pro-cyclicality in a downturn, it is significant that article 11 (4) of the directive de facto bans naked short selling. The ETUC welcomes this move but believes the formulation should become more explicit - AIF's have largely contributed to both asset price inflation *and* deflation.
- The directive should replace member states' current frameworks, and impose minimum standards in return for passport access for both AIF and AIFM, thus promoting the single market.
- Require equivalence of legislation before allowing non-EU funds access to EU markets.
- Liquidity and capital requirements and leverage caps to make individual alternative investment funds more robust and additionally reduce systemic risk and promote financial stability. Art. 25 (3) should include a provision connecting stricter caps on leverage according to the size of the AIF, effectively limiting the size of AIF or its capacity to leverage.
- Funds should be brought onshore. This combined with registration of investors will help promote transparency and sound regulation, minimise tax avoidance and tax evasion, and reduce the possibility of regulatory arbitrage to provide a global regulatory floor for AIF's.
- Insistence on the regulation of both funds and fund managers to minimise loopholes that would otherwise be exploited. Art. 2 should specify that institutions that are left out of the scope of this Directive pursuant to article 2 (2) a-g shall, for those AIF's they market in the Community, fully adhere to the requirements in articles 19 - 30, that relate to transparency, leverage and controlling influence of AIF's. Otherwise loopholes could arise because the directive, by exempting some institutions from the directive, implicitly also exempts them from the obligations at the level of AIF's.
- Comprehensive and regular reporting and increased transparency to help systemic risk oversight, allowing better due diligence, improving investor protection and promoting market integrity.
- Improving the regulation of operations including through the provision of independent valuation, better depository management, limits to delegation, better risk management and more diligent conduct of business. This will significantly reduce the risk of failure of funds and increase confidence in the system. This provides better investor protection and is good for systemic stability. The present text of the AIFM directive intends to remove the valuation function outside the AIFM to maintain independence. On the other hand this does not by itself guarantee better valuations. The valuating agency should be sufficiently equipped, capable, licensed, and supervised.

- Limit the exposure of public interest entities such as pension and insurance funds to AIFs to help protect consumers and retail investors from risks they do not understand and should not be exposed to.
- Monitoring, and when necessary regulating the exposure of systemically significant institutions, such as prime brokers and banks, to alternative investment funds, especially leveraged hedge fund and private equity firms, to help limit systemic risk. This also provides an indirect backstop in case direct regulation of the AIF's fails for some reason.
- Close tax loopholes such as the treatment of carried interest as income, which allow fund managers and investors to get away with paying lower tax rates than ordinary citizens.
- End overtly generous and asymmetric compensation structures which incentivize excessive risk taking. This will help improve investor protection, reduce social externalities and tackle systemic risk. The remuneration policy of the AIFM shall be such that it does not encourage risk-taking disproportionate to the risk profile of the AIF's it manages – as disclosed to its investors pursuant to art. 20 (1). The remuneration policy shall be so that the independence of the risk function, the compliance function and the valuation function is maintained.
- Improve corporate governance for a longer term perspective in activist hedge funds.
- Limiting asset stripping, controlling leverage and consulting workers will help improve financial stability as well as limit social externalities such as bankruptcies and associated job losses in private equity owned and controlled companies.
- AIF's acquiring companies should consult with employees and their union's representatives prior to takeover, during ownership and on the sale of the company acknowledging their role as legitimate stakeholders in the investment. Suppliers should also be consulted. AIF's should recognise and abide by existing collective agreements.

### **3. Regulation of Credit Rating Agencies (CRAs)**

CRAs contributed significantly to the current problems in the financial markets. They clearly underestimated the risk that the issuers of complex structured financial instruments may not repay the debts. Advising bond issuers and subsequently giving the highest possible ratings to many of those complex instruments without assessing properly or at least publicly acknowledging the risks can be attributed largely to a conflict of interest. The main CRAs are US-based private profit companies with no public accountability or general welfare considerations. Their revenues came from the very financial institutions seeking to sell their structured products, many of which were quickly revealed to be 'toxic'. As market conditions were worsening, CRAs failed to reflect this promptly

in their ratings. As a result, credit was granted even if it would not be justified by economic fundamentals, adding pressure to the financial bubble.

Based on a Commission proposal for a regulation (November 2008), the European Parliament and the Council agreed on the proposal on 23 April 2009. It sets up an obligation for all CRAs operating in the EU to register and comply with a set of rules. The approved provisions aim at enhancing transparency, independence and good governance of credit rating agencies, thus improving the quality and reliability of credit ratings and consumer's trust. The main objectives of the regulation are:

- to ensure that credit rating agencies avoid conflicts of interest, CRAs may not provide advisory services. Long lasting relationships with the same rated entities may compromise independence of those analysts in charge of approving credit ratings. Therefore, the regulation proposes that those analysts and persons approving credit ratings should be subject to a rotation mechanism;
- to increase transparency by setting disclosure obligations on the models, methodologies and key assumptions on which CRAs base their ratings;
- to ensure an efficient registration and supervision framework at EU level through a strengthened Committee of European Securities Regulators, i.e. the future European Securities and Markets Authority (ESMA);
- to improve the quality of the methodologies and the quality of ratings.

Enhancing independence and transparency of credit rating agencies is a positive step forward; however registration should not be left to national authorities. The ETUC believes that stronger rules are needed to clearly separate consulting from rating through 'Chinese wall' regulation. Transparent rating of assets and liabilities is a public good in open and transparent markets. Going further than the adopted regulation, the ETUC strongly advocates the EU to set up a public and independent, European non-profit organisation CRA, funded by the European budget under the supervision of a single European regulator. An advisory or supervisory board to this should include members from the EP, ETUC, BE and civil society organisations. Existing private CRAs should be held liable for the economic damage they are responsible for.

#### **4. For a full revision of the Capital Requirement Directive (CRD)**

European legislation on capital requirements has so far remained work in progress. Rules on capital standards and the possible utilisation of capital are listed in the Capital Requirement Directive (CRD) of 2006, which transposes the Basel II framework accord on credit institutions' capital adequacy into EU law and which is currently under revision. In parallel, the Basel Committee is currently working on a review of the definition of regulatory capital and of the minimum capital requirements. After the passing of the Solvency II directive in April 2009, the EP on 6 May 2009 adopted amendments to the credit requirements directives 2006/48/EC and 2006/49/EC, with regard to banks' exposure to risks, hybrid capital, banks' exposure to investment funds and risk management for securitised products. On 13 July, the Commission adopted further amendments

to the CRD which cover important areas of banking that are held responsible for much of the irrational exuberance in financial markets, namely capital requirements for securitisation and the trading book, as well as disclosure of securitisation and supervisory review of remuneration policy:

- Investment in "re-securitised products", in which multiple financial assets – such as mortgages – were pooled to form securitised financial products to be later sold to investors. Already securitised products were further combined and packaged into a single investment for resale which ultimately became impossible to understand for most market participants. Banks holding these highly complex products had insufficient capital to cover the huge losses incurred when the value of the underlying assets plummeted. Failure to disclose investments in securitised products undermined confidence as market participants became uncertain about banks' financial positions;
- Bonuses and executive pay: banks' remuneration policies have been based on perverse incentives geared to short-term success at the expense of long-term profitability and, in some cases rewarded outright failure. This has fostered a culture of excessive risk-taking. With the proposal, supervisory authorities are enabled to impose capital 'sanctions' on financial institutions, the remuneration policies of which are found to generate unacceptable risk. It is in line with the principles outlined in the Recommendation on Remuneration in the financial services sector (COM 2009, 211 fin) (see III. 6 below).

This first part of the revision process constitutes a positive step in the right direction. It has led to agreement on: -an increase (near doubling) of the amount of capital held against the trading book; -higher capital (almost trebling) to be held against re-securitizations; -a more rigorous capital adequacy regime for off balance sheet exposures; - the establishment of supervisors' colleges for the 40 largest cross border institutions operating in the EU, albeit their limited margins for manoeuvre (see above). However in addition to strengthened capital adequacy requirements for trading, securitisation and structured products, off balance sheet exposures and accounting as well as a regulation of incentives and limits to managers' compensation, further revisions of the CRD are required. It is important – when regulating incentives and remuneration structures in the finance sector – that it is without prejudice to the social partners' right to collectively bargain. This must be specified in the Directive itself and not only in the preamble.

For the ETUC, a forced reduction in the size, complexity and functionality of systemically important financial institutions, e.g. through variable taxation rates or capital requirements, would be equally important steps to stabilize the financial sector. Re-establishing a functional separation should lead to a more diverse banking landscape and smaller institutions that are closer to their clients. These would offset some of the huge employment losses in the banking sector and at the same time better respond to investment financing needs of the real economy than big conglomerates that easily become "too big to fail".

However, some member states and the UK in particular have explicitly rejected any such restrictions. It is therefore even more important to impose limits to borrowing and leverage of financial institutions so as to limit their appetite for risk exposure and increase their capacity of risk absorption.

Strengthening capital requirements must be co-coordinated internationally, at the level of the Basel based institutions, the Basel Committee on Bank Supervision and the Financial Stability Board, for many financial institutions operate globally and competition between the main financial centres would make it difficult for one country to go alone. Europe must speak with one voice in the negotiations.

Furthermore, the amount and variation of capital so as to reduce pro-cyclicality of capital, and the quantity and quality of liquidity buffers need to be included. The EU should not wait for an agreement on international guidelines to be reached before moving on its own legislative process.

As important as raising capital buffers generally is to ensure that they vary anti-cyclically, with the aim of reducing the pro-cyclicality of bank lending and risk taking. Enabling the authorities to increase capital requirements in an asset-specific way would enable them to target bubbles in specific sectors of asset classes, thus avoiding the difficult choice for monetary policy of deciding whether to choke off a bubble by raising the general level of interest rates, which impacts negatively on the entire economy. This is particularly valuable in the euro area with a one-size-fits-all monetary policy for economies that can be experiencing very different cyclical and financial conditions.

As far as accounting rules are concerned, the ETUC strongly advocates changes in the IFRS and US GAP standards which promote pro-cyclical mark-to-market accounting. In cases of important divergence between the purchasing price of an asset and its book value, methods of long-term, sustainable accounting should take preference for the lowest value.

ETUC supports the proposal put forward by UNI Europa Finance in April that colleges of supervisors should systematically include into their risk assessments experiences and information gathered by workers in finance institutions on the negative and positive impact of internal operating procedures and actual practices in companies. Furthermore ETUC supports UNI Europa Finance proposal for a charter on responsible sale of financial products. To minimise risk deriving from inappropriate business practices, each bank and insurance company should have a charter on responsible sale of financial products. The charter should make the company's principles explicit, public and verifiable as to selling products and services as well as relevant work practices. A key objective is to stop predatory sales practices and excessive risk taking. At the centre of the financial business should be excellent customer services (for more details see: UNI Europa Finance, Contribution to the European Commission's consultation on financial markets supervision, April 2009).

## **5. Derivatives and OTC trade**

On 3 July, the Commission adopted a Communication on Ensuring efficient, safe and sound derivatives markets. The collapse of large banks in the US and Europe has highlighted the significant role played by derivatives in general and Credit Default Swaps (CDS) in particular. The risks associated with CDS are especially present in the 'over the counter' (OTC) derivative markets which are characterised by non-transparent, private contracting with limited public information, and a complex web of mutual dependence. They have largely undermined financial stability and contributed to uncertainty.

At the peak of the financial bubble in summer 2008, OTC trading of derivatives was eight times as high as the volume of derivative trading on stock exchanges. Trading of foreign exchange derivatives, interest rate derivatives, equity derivatives, commodity derivatives and credit derivatives, by agents having no interest in the underlying assets only facilitates speculation, volatility and the building up of risks in the system. It is equal to gambling with no economic benefit attached to it apart for the winning gamblers and raises serious conflicts of interest. Hence some of the derivative products should simply be banned. However, some derivative products are vital to enable companies in the real economy to hedge against the risks of unexpected price shifts and thus facilitate long-term planning, e.g. in exchange rates or commodity prices. One advantage of introducing a Europe-wide FTT (see above) would be that it would contribute to dampen speculation in derivative markets (involving 'high frequency' trading) while not penalising genuine hedging transactions (which arise less frequently).

The Commission in its communication has announced to come up with proposals for detailed legislation on derivatives and OTC trade by the end of this year. In the forthcoming months the ETUC, together with UNI Europa Finance and in cooperation with affiliates will monitor this closely and will put forward concrete proposals once the Commission proposal is on the table. In the meantime, the following principles should apply:

- Standardisation: the ETUC welcomes the Commission's commitment to standardize all OTC derivatives. Non-standardized products and derivatives with insufficient liquidity should be banned from trading;
- Capital requirements for OTC derivative trading should be higher than those on regulated markets (on-exchange clearing);
- Clearing should take place at central market level, following the example of on-exchange clearing; possible exemptions allowing for bilateral derivative OTC trading should be restricted to non-financial entities (most notably for exchange rate swaps) but banned explicitly for financial institutions;

- All derivative trading, in particular CDS trading, should mandatorily take place through a Central Counter-party (CCP) that would need to be set up at European level;
- European clearing houses would significantly enhance transparency of derivative markets and fall under European bank regulation.

## **6. Remuneration**

The European Commission has adopted a Recommendation on remuneration in the financial services sector (COM 2009, 211 fin). It recommends that Member States should ensure that financial institutions have remuneration policies for staff that are consistent with and promote sound and effective risk-management. The Recommendation sets out guidelines on the structure of pay, on the process of design and implementation of remuneration policies and on the role of supervisory authorities in the review of remuneration policies of financial institutions. The Recommendation invites Member States to adopt measures in four areas: (1) structure of pay (2) governance (3) disclosure and (4) supervision. With the proposal on amendments of the Capital Requirements' Directive, remuneration schemes will be brought within the scope of prudential oversight (see III. 4).

The Commission has also adopted a recommendation on directors' pay (COM 2009, 3177). The Recommendation invites Member States to:

- (1) set a limit (2 years maximum of fixed component of directors' pay) on severance pay (golden parachutes) and to ban severance pay in case of failure;
- (2) require a balance between fixed and variable pay and link variable pay to predetermined and measurable performance criteria to strengthen the link between performance and pay;
- (3) promote the long term sustainability of companies through a balance between long and short term performance criteria of directors' remuneration, deferment of variable pay, a minimum vesting period for stock options and shares (at least three years); retention of part of shares until the end of employment; and
- (4) allow companies to reclaim variable pay paid on the basis of data, which proved to be manifestly misstated ("clawback").

In the Pittsburgh G20 Summit Declaration, heads of state reiterated their commitment to "governance that aligns compensation with long-term performance" (para 13). ETUC supports the opinion of UNI Europa Finance that the focus on remuneration structures and risk management should not only stay with remuneration of top executives and traders. Remuneration structures and incentive systems for employees at lower levels play a major systemic role in risk management and are a potential destabilising factor in financial markets. Appropriate remuneration systems are key to ensure the development of a new long-term oriented, risk-conscious business model (see more in detail: UNI Europa Finance, Contribution to the Commission's recommendation on remuneration in the financial service sector, 6. April 2009). The ETUC therefore

welcomes the two Recommendations and the proposal on CRD amendments to bring remuneration within prudential oversight.

#### **IV Conclusion – Europe risks missing an opportunity for real financial reform**

The model of unleashed neo-liberal financialisation has failed. The Commission's proposals for financial reform constitute first positive steps in the right direction yet European policy towards financial market regulation falls short of providing a comprehensive and satisfactory answer to the fundamental flaws of financial capitalism and global macro-economic imbalances. The greatest risk in the legislative process ahead is that merely small and incremental changes to the regulatory regime would return Europe and the world to business as usual – until the next major financial crisis hits. The financial sector must bear a substantial share of the costs it has caused.

Europe's failure to address the financial crisis with sufficient energy could ultimately lead to its political failure. This must be avoided. Trade unions in Europe will not accept that a superficial repair of the financial system is being paid by job losses, massive unemployment and higher taxes on labour. For the ETUC, a fundamental overhaul of the current financial system is needed.