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Financial crisis : background note for the Roundtable on financial crisis

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Preliminary remark :

As a general principle, the integration of the European financial markets can contribute to the achievement of the Lisbon-Göteborg Strategy, provided the respect of three major conditions :
a) need to ensuring effective **financing of long-term investments**, which are crucial to attaining the Lisbon-Göteborg objectives (for example : to tackle climate change and energy policies) ;
b) need to addressing market imperfections (due to non-transparency, asymmetric information,...) ;
c) need to combat systemic risks to the stability of the financial market by strong prudential rules & supervision.

Key issues to address for the Greens and key proposals to cope with the financial crisis

1. Financial innovation and the use of "securitisation" as a lending practise :
Issue at stake : Through this mechanism (illustrated by the sub-prime crisis), loans are repackaged in securities [1]. While these new sophisticated **risk transfer (CRT) instruments** were supposed to diminish risks and enhance the efficiency of the markets, they resulted in increasing the risks by spreading the "toxic assets" throughout the financial system.
Proposal of the Greens : to limit the use of "securitisation".
How ? Through the revision of the **Capital Requirement Directive**, whose new proposal has been put on the table since 1 October.
Proposal of the Commission : Banks that sell securitised products or repackaged debt such as those that turned toxic will have to share the risks with the buyers.
To reach that goal, banks will have to retain 5% of these products in their balance sheet.
Comments :

- the PSE, the GUE and the Greens favour this measure, but is combated till now by the EPP (with the support of many MEPs of the ALDE) on the grounds that it will kill the "securitisation market" ;

- Banks oppose fiercefuly to this measure : for this reason, Mc Creevy had to side back. While his first proposal was 10%, he backed down to 5%.

- **The Greens shall at least cling to the objective of 10% as initially proposed by the Commission.**

2. Supervision :
Issues at stake :
EU countries' existing tools are no longer adequate to contain the impact of financial crisis in ways that minimize collective costs and avoid moral hazard.
Indeed, there are more and more pan-European banks, whose activities span several countries. However, financial stability arrangements, notably banking supervision, remain meanwhile nationally anchored. This means that in case of an unfolding financial crisis, no national authority acting as ultimate supervisor of a pan-European bank will have the full means to respond to it, since it will always need to rely on full cooperation from its fellow supervisors, who are working in different legal settings.
In order words, considering that the statutes, competences, enforcement and sanctioning powers of supervisors continue to differ importantly, prudential fragmentation is a key issue to address. **The fact that financial supervision has not kept pace with market integration is indeed an aggravated factor to the contagion of the crisis, since they were not able to have a European view of risks created by these new complex financial innovations.**

New proposal of the Commission (1 October 2008) : colleges of supervisors will have to be set up for all cross-border banks with the bank's home supervisor having a "last say".

Proposal of the Greens :
The proposal of the Commission will be a step in the right direction, but it is not enough. Considering that a European view of risk exposures, a European prudential oversight body, and a European structure to allow for rapid exchange of information and a clear assignment of supervisory responsibilities are still lacking, the Greens deem it essential **to set-up a EU supervisory body**.
This EU supervisory authority shall be able to collect and analyse micro and macro prudential information with the central banks, and should act as a rapid reaction force in crisis situations with a systemic impact for the EU.

3. **Interdependence between a regulated and non-regulated markets, such as hedge funds** :
Issue to address : There is a relationships between hedge funds and investment banks, which lend them money (counterparty risks). Given the partial overview these lenders usually have of overall fund's credit lines, the banks' exposure to risks is therefore difficult to assess. And this is all the more problematic that the **extreme rewards** offered to hedge funds managers [2] provide a clear incentive to engage in highly risky investments, and that hedge funds are precisely characterized by their use of **higher level of leverage**. As it implies a high degree of indebtedness, it clearly can have detrimental effects in case of financial market crisis and they pose a threat of sytemic risks.
For the Greens : Why regulation on hedge funds is part of the answer to give to the financial crisis :
As a matter of fact, financial innovation, and especially the **securitisation process,** has enabled banks to transfer their credit risks to other financial actors. Considering that a **strong interdependency** exists between all financial actors, the coexistence of a lightly and unregulated market (including private pools of capital such as private equity funds and hedge funds) alongside tightly regulated institutions such as pension funds, insurance companies, banks, etc., has therefore increased financial instability, as the responsibility of banks as regards credit risks' has been transferred in fine to hedge funds. Therefore, hedge funds have to be regulated for the Greens on two grounds : 1) **there is no level playing field** for all actors (it is therefore a distortion of competition) ; 2) in view of the relationship between hedge funds & private equity and commercial banks, institutional investors (including pension funds, etc.), the characteristics of hedge funds (opacity, performance fees, etc.) pose potential **systemic risk**.

Proposals of the Commission :
So far, Mc Creevy clings to the idea that "code of conduct" are enough for hedge funds.

Proposal of Rasmussen report : Last September 08, the EP requested i.e. from the Commission to legislate in respect with hedge funds on transparency requirements : the idea being i.e. that banks have the information necessary to assess their risks exposure and their liquidity. In this sense, the improvement of **transparency** and **disclosure of informati**on is a core element of market discipline advocated in Rasmussen report. Another key point of its report being to make **capital requirements mandatory for all financial institutions**, reflecting risks.

Additional requests of the Greens :

- to set up a **EU framework for the registration and authorisation** of hedge funds and hedge funds managers ;

- to set up a **EU register for structured products** ;

- to set up a **EU supervisory structure** to cover all financial services sectors so as to help preserving financial stability.

- to set **limits on excessive indebtedness**, which is precisely one of the technique used by these kind of funds to enhance their profits.

4. State Aids and Competition law :

Key issues to address : the Irish decision to decide unilaterally to set out a two-year guarantee on deposits with the six largest Irish banks (totalling 400 billion euros) has triggered off criticisms and concerns for the following reasons :
a) It creates distortion of competition between Irish bank (which benefit from these "state aids"), and foreign banks represented in Ireland (which didn't receive the same advantages) ;
b) It forces upon the other MS to offer the same guarantees so as to avoid that "this unilateral decision" will foster the contagion of the crisis. Indeed, this difference of treatment has the side-effect to encourage savers to go the banks offering the best guarantees. Therefore, the lack of coordination of Member States on this field is to accentuate the destabilisation of banks.
Position of the Greens :
General line of the Commission, as confirmed by the c*onclusions of the ECOFIN Council of 8 October 2008,* is OK as regards the need to take into account "exceptional circumstances". However, other key issues need to be addressed :

- The ECOFIN Council pledges for more coordination of national actions, but the idea of a common emergency fund was dismissed. There is a need to have **clear guidelines** and a **European framework** from Commissioner Kroës on the compatibility of recapitalisation and guarantee scheme with state aid regimes, as well as a **solidarity mechanism**.

- There is a need to assess the role of **bank consolidation** (advocated by Commissioner Kroës) on the contagion of the crisis ;

- The role of **credit rating agencies** have been highly criticized in the spread of the crisis. Credit rating agencies is a sector dominated by a handful of companies. This crisis proves that the initial concerns to be raised by market concentration in such sector is all the more acute. Kroës needs to come up with concrete proposals to combat such abuse of the markets. Beside, the Greens oppose to dealing the conflict of interest facing credit rating agencies just by a code of conduct. A regulation or a directive of Mc Creevy on this issue is waited for November.

5. Revision of EU directive on bank deposit guarantee scheme

Issue at stake :
Directive 94/19/EC on deposit guarantee schemes imposes on all member states the obligation to establish a compensation scheme for depositors. It sets a minimum level of guarantee of 20,000 euro, which means that in the event of the bankruptcy of a bank, depositors throughout the EU have the guarantee of recuperating their money up to this sum. However, some member states have introduced higher guarantee ceilings, and the way in which the systems work in practice has not been standardised either.

As explained hereabove, the Irish decision illustrates why in case of financial turmoil these differences worsen the impact of the financial crisis.

Position of the Commission so far :
Till now, Commissioner Mc Creevy took the view, on the basis of a consultation launched in July 2005, that there was no need to legislate : Directive 94/19/EC has therefore stayed intact. To correct imperfections in the system, the Commission recommended self-regulation.

Between times, the amplitude taken by the financial turmoil relaunched the prospect of recasting this directive.

For the Greens :
The financial crisis makes a strong case for having an in-depth recasting of the **Directive 94/19/EC on deposit guarantee schemes**, especially in case of systemic risks, during which maximal harmonisation of guarantee funds could be foreseen.

6. Other key measures to be taken to address the financial crisis at its roots :

introduction of a **type of Tobin tax** to fight against financial speculation and to give the Commission a mandate to strive for an international agreement committing all signatories to impose such a tax on financial transactions.

to tackle **fiscal paradise**, where i.e. hedge funds are located for "light regulation" and tax-minimising reasons ;

corporate governance : to ensure that remuneration scheme is related to performance, and to limit managers' income.
enhance the role of the **European Investment Bank** to prevent a credit crunch from occurring (in line with the ECOFIN conclusions of 8 October 2008) and to ensure long-term financing, especially to achieve the goals set by the climate-energy package.
to enlarge the mandate of the **European Central Bank** to financial stability, and to enhance its role in supervision, while ensuring political accountability, etc.
last but not least, to redefine a new Bretton Woods, in the context of the **IMF** (to develop).

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[1] "Securitisation" (titrisation in French) has been used as a tool to diminish the risks. Through this process, investors now have a much wider range of instruments at their disposal to price, repackage and disperse credit risk throughout the financial system.

[2] Management fee amount on a average of 2% of the net asset value of the fund, while they receive as well a percentage of fund's annual profits (performance or incentive fee o 20%).

