



Newsletter - EU Financial Reforms

July 2011

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Editorial

This newsletter is being published in the middle of financial and monetary turmoil that is getting worse by the day in the European Union (EU) and Euro zone. Clearly, the financial costs of resolving the financial crisis that erupted in September 2008 are now taking a heavy toll on the economy, democracy and society of Greece, Ireland and Portugal. These countries now have been rated with a 'junk' status for investors and creditors who also lost confidence in Italy. The pain is equally felt in other countries such as Spain, the UK and the Netherlands, where public spending is being cut even if large protests take place. Worse, the 'light touch' financial reforms undertaken so far have failed to provide suitable instruments for fighting the crisis, as is explained in this Newsletter.

The credit rating agencies (CRAs) are being criticised for abruptly lowering countries' credit ratings so that countries, and their banks and companies, cannot gain access to finance any more. Reforms, however, have failed to strictly regulate them so that further reforms are now being called for. The regulation of credit default swaps and short selling as well as non-transparent (OTC) over-the-counter derivatives, which are important speculative financial market instruments that have worsened the crisis, is still not being decided on at the EU level! Many fundamental financial reforms still have yet to be proposed, and are likely to be decided upon only

after months of EU level discussions and conflicts. These include reforms to ensure that banks have enough capital reserves to deal with defaults and full regulation of all derivatives markets, including those that speculate on food prices.

A wide range of diverse interests from governments and financial actors have been weakening and severely slowing down decision making on financial reforms at the EU level. Mostly, solutions are sought in old models, such as the new EU Economic Governance package and austerity packages, which implement the old neo-liberal economic policies and budgetary restrictions and which are lacking in credibility. Even the 'stress test' of the largest 90 banks in the EU by the new European Banking Authority has not been seen as fully credible. The stress test showed that some banks were still not strong enough to withstand in worsening crisis scenarios while other banks were stronger than the financial speculators assumed.

The lack of reform progress can also be seen at G20 level. The US is afraid to introduce stricter regulation of derivatives than the EU and the EU complains that the US regulates less in other areas such as banking and remuneration reforms. The G20 Agricultural Ministers, who met for the first time on 22-23 June 2011 after arduous preparations, did not even decide on how financial markets could be prevented from excessively speculation on food and other commodity prices.

The crisis and budgetary constraints have now moved the Commission to propose for a financial transaction tax (FTT) at the EU level, even if not agreed at the G20 level. The revenues would go to the EU, and not to anti-poverty and sustainable development measures as civil society has been campaigning for for years. Civil society is increasingly able to have its voice heard through public protests and campaigns, letters written by the public and civil society organisations, and even dialogues with decision makers. However, the interests of the financial sector still dominate and civil society demands are – so far – hardly integrated in the reforms. It is time that decision makers and the financial sector change their old ways of acting and thinking before the crisis gets completely out of hand. Remember, many crises have broken out in the month of September.

Dramatic climax of the Euro crisis while financial market reforms are delayed



The Euro crisis has definitively turned into a systemic crisis since the beginning of Summer 2011. After Greece, Ireland and Portugal had received huge rescue packages combined with strict austerity programmes, the Greek programme has already failed. Long high level discussions take place how to provide the country with a second rescue package of around €115 billion. Early in July, even Italian bonds and banks became the target of speculative attacks. The very existence of the Euro is at stake. The muddling through, as the EU did in the last year, can clearly not work anymore, certainly not if no quick reforms of the financial markets are being effected, as is currently the case. For instance, early July there was still no final agreement to regulate [credit default swaps](#) and [short selling](#), key instruments in financial market turmoil against which governments are fighting. Thorough reforms of the heavily criticised credit rating agencies, who downgraded Greece, Ireland and Portugal to 'junk' status, would also have to wait (see other article in this newsletter: [How the three big Credit Rating Agencies \(CRAs\) are criticised and circumvented](#)).

Over the last months, the crisis in the Euro zone has taken a dramatic turn of historic dimensions:

- A second rescue package of around €115 billion for Greece proved to be necessary in 2011 to allow the government to continue payment of its debts and other necessary state expenses. A first rescue package of €110 bn in 2010 had involved huge budget cuts and other austerity measures against which there were violent protests in the street. However, after two months of negotiations, at the begin of July 2011 there was still no agreement on important elements for the second rescue package, such as whether and how the private (banking) sector needs to contribute (see below).
- Portugal, too, had to ask for support from the EU crisis fund and received €78 bn in May 2011. The country had to adopt a heavy austerity programme.
- In spite of the rescue measures, the big rating agencies nevertheless downgraded once again Greece, Portugal and Ireland in June and July, down to 'junk' status(see other article in this newsletter: [How the three big Credit Rating Agencies \(CRAs\) are criticised and circumvented](#)).
- In the first week of July, Italy, the third biggest economy of the Euro zone, came under attack by the financial markets and had to introduce an austerity package of €45 billion in budget cuts.

In conclusion, the management of the crisis in the Euro zone during the last 15 months has failed. The financial markets are still able to determine the fate of Europe's financial system and economy. This is a systemic crisis, as even hard core optimists among the politicians begin to understand, which might have global dramatic repercussions.

The Greek drama – second act

The first act of the Greek drama was staged in spring 2010. After long resistance, particularly from Germany, the Euro zone discussed a rescue package for Greece in June 2010 in order to prevent it from becoming insolvent: The country needed €120 bn. In a joint action by the Euro zone, the IMF and the European Central Bank (the so-called Troika) Greece received €110 bn for three years. The bailout package was conditioned with austerity measures in the tradition of the neo-liberal Washington consensus: Reduction in salaries for the public sector, increase of the VAT and other indirect taxes, reduction of social expenditures and privatisations. The idea was that through the austerity measures Greece could grow out of the debt trap. The program was implemented, ignoring the criticisms and protests of many heterodox economists, trade unions and civil society, who warned that the programme would lead to an economic downturn.

In April 2011, it became obvious that the programme was wrong footed as critics had pointed out. Although the country had succeeded to reduce its 2010 budget deficit by 4.9% (from 15.4% to 10.5%) the economic growth rate continued to shrink by 4.3%. The overall debt rate went up to 142.8% of GNP, rather than going down. There were dramatic social consequences: Unemployment went up to 12.6% already at the end of 2010. Unemployment of young people skyrocketed to 32.9%. Twenty percent of the population lives under the poverty line, 22% of people above 65 years.

The failure of the programme opened the way for another wave of speculative attacks by the financial markets in 2011, speculating that Greece would have to default on its debt (bond) payments. Speculators' attacks followed the same pattern as in 2010:

- Investment banks like *Goldman & Sachs* or *Deutsche Bank* as well as [hedge funds](#) purchase [credit default swaps](#) (CDS, a credit derivative that insures against default) of Greek (or Portuguese etc.), which investors can purchase even if they do not own the related bonds.

- Increasing demand increases the prices of CDS and is interpreted as a confirmation that the situation of Greece is worsening. A typical case of a self-fulfilling prophecy.
- The [credit rating agencies](#) (CRAs) realize the increase of the CDS price and interpret it as a worsening of the Greek situation. They downgrade the rating of the country, which has severe consequences on investors' behaviour.
- This drives the price of the CDS even more up and gives an extra short term profit to the sellers of the CDS (e.g. investment banks who are selling CDS have no interest in a default on Greek bonds since they would then have to pay the buyers of CDS).
- Banks and insurance companies that hold Greek bonds without speculating, are afraid of the situation and sell their Greek bonds. In many cases they are even obliged by law to sell after an asset is downgraded to a certain low grade. As a part of the international bank standards (set by the of the Basel Committee of Banking Supervision) and national regulation, banks have to sell assets whose value falls under a certain threshold in rating.
- Parallel to or combined with CDS deals, [naked short selling](#) operations on Greek bonds are undertaken. Short selling is speculation on falling prices, and is so far hardly transparent or regulated ([see paragraph below: "Credit default swaps \(CDS\) still not regulated"](#)): The speculator borrows CDS at a low price (or purchases an option to buy them) before the downgrade of a bond. The speculator sells the bond before the bond is downgraded. He buys back the bond at a lower price after the bond is downgraded and makes a gain of the difference between the price at which he sold the borrowed bond and the price at which he bought back the downgraded bond to give it back to the lender. In the case of naked short selling, the speculator even does not borrow the bond but buys it back on the market (with the risk that it is not available). If many Greek bonds are sold at the same time through short selling, their price can go down.
- As a result Greece could only issue new bonds or reschedule old ones at a very high interest rate, 20%, which is unsustainable and hugely increasing the debt burden.

In May 2011 the debate for a second rescue package for Greece started. The Greek government and parliament were put under heavy pressure to accept a new package by the Troïka. The package followed the same logic as the one in 2010 that had failed: more budget cuts, more privatisations etc. while trying to raise some more taxes. In spite of massive protests from the trade unions and the population the parliament finally adopted on 29-30 June an austerity programme of €40 bn in spending cuts, tax rises and state asset sales. In the meantime, the EU countries were still bickering among themselves whether the private sector should be involved or not, and if yes, how.

Haircut – quarrel in the barber's shop

During the discussions about the second bail-out package of €115 bn, unlike for the first rescue package, several countries, among them Germany, the Netherlands and Finland, wanted to make the private sector, especially banks who hold Greek bonds, contribute on a "voluntary basis." This would happen through a reduction of the price, in this case of the Greek bonds, which is often referred to as a (non-voluntary or voluntary) 'haircut'.

France, whose banks were holding many Greek bonds, was against such involvement of the private sector and made a proposal that was a rather soft solution for the banks: At the time that the bond payment was due, the banks would mostly use the payment of the bonds by Greece to buy new very long term bonds of Greece. This would not really reduce the long term debt burden of Greece.

By 12 July, there were nine different technical models under discussion. One option was that the European Stability Mechanism would help Greece finance to the buy back its bonds, which are being sold on the market at 40-50% of their value. Most proposed solutions would lead to a de facto reduction of the Greek debt burden between 20% and 30%. Since the three largest rating agencies threatened to, and then did, classify such operations as a 'selective default', there was no agreement among most of the European decision makers because a 'selective default' has severe consequences for the behaviour of investors. A reduction in the value of the Greek bonds,

a haircut, was also opposed by the ECB who is the biggest holder of Greek bonds and would lose money. Moreover, the ECB announced it could no longer accept Greek bonds as collateral in case of default. Under these conditions it was not surprising that the banks who had been invited to negotiations refused any voluntary agreement.

When this newsletter went to press, the final decision was still pending. A summit was scheduled for 21 July 2011: Chancellor Merkel said she would only attend if a solution was on the table. Since many criticised the delay of the final political decision because it was affecting other countries and financial markets, a decision might be accelerated in the light of a new and even more dramatic events, such as continued speculative attacks on Italy.

The case of Italy

On 11 July 2011, the interest rates for Italian bonds suddenly went up by 2.8% to 5.9 %. This is more than the double interest rate for German bonds and the highest rate for Italian bonds since the introduction of the Euro. The trigger for the speculative attack by the financial markets, using the same mechanisms as described above, were the rumours that the Italian Minister of Finance, Tremonti, might resign. He had conflicts with Berlusconi and was involved in a financial scandal. The deeper reasons for the attack, however, were Italy's public debts of € 1.6 trillion, which is 120% of Italian GDP and for an important part in the form bonds. This is the highest rate after Greece in the EU. Also the growth rate of Italy was with 0.9% between 2000 and 2005 and -0.4% since 2006, which is below the European average. Productivity has been stagnating since 2000. Finally, Berlusconi is, with his sex scandals and the involvement in several corruption cases, a heavy burden for the country.

On the other hand, there are significant differences between Italy and the smaller indebted countries. 55% of the public debt is held by domestic banks and investors. The banking sector is stable and came through the crisis in 2008 well, since it was not involved in complex risky financial products. The bank stress test published on 15 July 2011 (see other article in this Newsletter: [Banks in the spot light](#)) showed the strength of the Italian banks which contrasted with the lack of confidence they faced the week before. Italy is a highly industrialised country, which has the potential to get rid of its debt.

Italy reacted quickly to the pressure of the speculative attacks by the financial markets and adopted on 15 July an austerity programme of over €45 bn until 2014. How events will further develop is not clear since financial crises have shown that problems arise, where they are not expected. In any case, the size of the Italian economy would make it impossible to rescue the country with a bailout package from European countries. However, the low pace of political decision making, compared with the speed of the financial markets, is especially being pointed at.

What is needed

The Euro crisis shows once again, that the globalisation of finance has led to a system where politics, even of big countries and the entire EU, are helpless vis à vis the mechanisms of financial markets and their instruments, such as the rating agencies. So far, the 'light touch' reforms at EU level have shown to be insufficient or even non-existent. For instance, the new legislation to control naked short selling, is not yet agreed on by the Ministers of Finance (see below). Also, the lack of reform of decision-making procedures and lack of solidarity in the EU, which has become less and less democratic, to provide debt relief is also taking its toll.

The crisis has reached such grave dimensions that the only solution seems to be strictly controlling the financial markets and financial speculation, such as banning short selling of, and CDS on, sovereign bonds, and neutralising credit rating agencies. This would interrupt the pro-cyclical and mutual reinforcement of downgrading and speculative attacks. As UNCTAD has put it: ["Nothing short of closing down the big casino will bring a lasting solution."](#)

Credit default swaps (CDS) still not regulated

Speculation against the bonds issued by the countries with huge budget deficits, has been an important factor in worsening the crisis. These countries had to increase the interest they offered when they had to issue new bonds, thus increasing their debt burden. As explained above, credit default swaps (CDS) and the practice of naked short selling are key speculative instruments by the financial markets. Germany had already banned naked short selling in 2010. Regulation naked short selling and CDS is in the decision making process at EU level since September 2010 and still not finalised.

On 5 July 2011, the European Parliament (EP) supported in plenary a draft legal text that proposes to regulate short selling and CDS, including CDS on governmental bonds. The EP did not forbid short selling nor ban the use of naked short selling outright, but did limit its use by requiring that traders get the security that they did not own during the naked short selling transaction, by the end of each trading day. However, supervisory authorities have the right to restrict short selling and CDS selling in special circumstances and fines for abuses are to be dissuasive. The EP also introduced provisions to restrict abusive trading of CDS and speculation that drives up prices of related assets. The draft EU legislation provides for instruments that ensure more transparency (especially for authorities) in short selling and CDS trade, and aims at a single set of rules in the different EU countries.

The EP now has to agree on a compromise text with the Council of Finance Ministers who had not decided yet on their own position in order to come to a final legislative text in 'first reading.' Due to the fierce lobbying by the financial sector, concerns are raised by some MEPs that the lobby will weaken the EP draft legal text in its final stages. The conservatives, who are close to the financial industry, are already warning that a ban on naked short selling would make the financial sector create increasingly complex financial products and increase instability by creating further doubt in already stressed bond markets. Negotiations between the EP and the Council are expected to start in September 2011. However, the situation in Greece, Portugal and Ireland shows that this legislation is urgently needed to stop 'the financial markets' aggravating the financial and economic crisis by increasing speculation over a country's bankruptcy.

^ photo by [Cesar Pics](#)

How the three big Credit Rating Agencies (CRAs) are criticised and circumvented

The debt crises of Greece, Portugal and Ireland, that lead to the Euro crisis, reveal the crucial role played by a mere three rating agencies who have been determining whether governments have access to finance or not. In addition, these three played an important role in undermining the credibility of the rescue packages agreed by politicians. After some earlier, weak EU reforms of [credit rating agencies \(CRAs\)](#), the European Commission has now announced further reforms of CRAs, to be presented in November 2011. These reforms are aimed at achieving more independence from the three big CRAs, something long overdue, as discussed in [Newsletter nr. 5](#). The ECB has recently been using the rating of the unknown but officially recognised Canadian agency DBRS to circumvent the ratings of Standard & Poor, Moody's and Fitch.



The three big US credit rating agencies Standard & Poor (S&P), Moody's and Fitch dominate up to 90% of the world market for ratings of governments and companies that want to receive loans or investments. The role of credit rating agencies in the European sovereign-debt crisis has become the subject of extensive and heated debate after they successively downgraded Greece

(June), Portugal (5 July 2011) and Ireland (12 July 2011) to junk status. These downgrades mean that investors are being told there is high risk that any money they invest in bonds of these countries will not be paid back in full. Rating agencies were much more lightly reformed in the EU than in the US after the financial crisis. Further reforms of CRAs, such as breaking the oligopoly by three CRAs in a world market, have been pending, as explained in [Newsletter nr. 5](#). Although their ratings were proven wrong in almost all financial crises of the last two decades, the ratings of the three big rating agencies are still accepted by most investors and financial markets all over the world. Up to recently, EU governments and the European Central Bank (ECB) also accepted the ratings of these CRAs as very important evaluators of government, companies and others requiring a loan. Their ratings have been used as legal benchmarks in investment and lending rules for banks, insurances, many investment funds and other institutional investors. In other words, politicians and regulators are themselves also partly responsible for the problem. As a result of the legal entrenchment, many institutional investors are legally obliged to follow the ratings.

Consequently, CRAs have the power to decide not only on the creditworthiness of a single company, but also of democratic countries. Downgrading or low rates for of countries mean that loans can only obtained at very high interest rates, or not at all, from commercial lenders or bond buyers, which has negative impacts on the entire economy of a country and its population.

The CRAs and the Euro-zone

In the Euro crisis, European politicians are now learning that their efforts to rescue the EU countries with high deficits and financial problems are useless, if the 'big three' decide otherwise. For example, in early June, S&P downgraded Greece and rendered it the lowest rated government in the world. This meant that Greek government bonds needed to be issued with very high returns to investors, thus augmenting the country's debt problems. Greece criticised this decision in light of the fact that their discussions with the European Commission, the ECB and the IMF had not yet been concluded.

Moreover, this downgrading had followed closely on the heels of a downgrade in May 2011 from Fitch, which Fitch claimed to reflect the scale of the challenge facing Greece in implementing a radical fiscal and structural reform programme necessary to secure solvency of the state and economic recovery. Furthermore, Moody's had downgraded Greece on 1 June 2011, arguing that it was increasingly probable that Greece would have to restructure its debt, and that there was a 50-50 chance of this. A reality politicians refused to consider at that time, but which they needed to face in July 2011. However, in June Greece hit back and argued that this downgrade was influenced by intense rumours in the media and overlooked the Greek government's pledges to achieve its fiscal targets for 2011 and to accelerate privatizations.'

Moody's downgrading of Portugal to 'junk' status on 5 July only added fuel to the fire. Moody's reasoning here was that Portugal, like Greece, would not be able to meet the deficit reduction targets specified in its bail-out agreement, and that it ultimately would need further commercial loans or a second bailout. The Portuguese government, the European Commission and others all argued that this very low rating was arrived at without sound evidence or information.

Early in July, S&P derailed Sarkozy's 'debt rollover' plan for Greece (whereby, when a bond matures, bond holders would reinvest 70% of the payment of that bond in new 30-year bonds). S&P also worsened the crisis by declaring that the Greek government's financing needs in 2011-2014 could require private sector debt restructuring in a form that S&P would declare an 'effective default' of Greece's debt obligations under S&P ratings criteria.

On 12 July, Moody's downgraded Ireland to junk status, stating that private debt restructuring might be needed in the future. However, this started to look like a self-fulfilling prophecy as junk status makes Ireland's access to finance much more costly, thus increasing its debt and economic problems, and making debt restructuring with participation of the private sector even

more necessary. The European Commission reacted angrily to the downgrade that took place just before a press conference by the IMF and EU about how Ireland was on track with meeting its budget cuts targets. However, some market researchers are more sympathetic towards Moody's: ["Ireland has been trading equivalent to a junk credit for many months."](#)

Using an unknown CRA

In July, the ECB tried to reduce its dependence of the powerful three dominating rating agencies who downgraded Greece and Portugal to junk status. The ECB argued that not only the 'big three' were given official legitimacy, but also a fourth one: the Canadian [Dominion Bond Rating Service \(DBRS\)](#). Only few [insiders](#) knew about the existence of DBRS and its official status. DBRS had not downgraded Greece so that the ECB could argue that until all four CRAs had not downgraded Greece to junk status, it was legitimate for the ECB to purchase Greek bonds and accept them as collateral for loans to Greek banks. However, reducing the power of the US agencies is not a sustainable solution. Central banks should become really independent from the influence of the rating agencies by being able to fully rate themselves in a credible way.

On 6 July, the President of the European Commission, Barroso, spoke out strongly against the agencies. He announced that the European Commission was considering to take measures to improve the methodology and transparency of the rating of bonds to reduce excessive reliance by banks and other financial institutions on the ratings, to further reduce conflicts of interest and introduce more competition. Commissioner Barnier, responsible for regulating the financial market, announced 'stiff measures' in November 2011 ["to reduce the power of the agencies, such as forcing them to justify their decisions by revealing the details of their analyses and criteria, and scrutinising whether they are properly registered in Europe"](#). It is not clear if these measures will be on time or too late, if they will be sufficient or not, and will provide more credible and independent ratings. The proposals will only become fully clear in November, after which the implementation will also cost time. The European Parliament already voted in June 2011 on a non-legislative resolution calling for credit rating agencies to be made liable in civil law for their ratings, and to create a European credit rating foundation. They also called for special attention to be paid to sovereign debt ratings. New rules for credit rating agencies should also clarify their working methods, boost competition and reduce reliance on their ratings, said the resolution.

New Economic Governance – the EU sticks to neo-liberal recipes



The EU has been further discussing a package of proposals to better coordinate economic policies and avoid crises in the Euro zone, as explained in the [previous Newsletter nr. 6](#). The main purpose remains to impose stricter budget discipline on member countries even including sanctions for those in the Euro zone. The economic governance package has been criticised by trade unions and social movements for being another neo-liberal recipe, while the problems require new and different solutions.

On 18 June 2011, the heads of state meeting at the European Council adopted a programme for new Economic Governance at EU level in response to the dramatic sovereign-debt crisis in several EU countries. The Economic

Governance package is known as 'six pack' as it consists of six legislative proposals. It is complementary to the [European Stability Mechanism \(explained in Newsletter nr 6\)](#), which provides financial support for indebted member countries.

The core of the 'six pack' is a programme for the surveillance of national budgets, the so-called European Semester. The Economic Governance programme is meant to discipline the fiscal policies of member states and to correct major macro-economic imbalances (see also [Newsletter nr 6](#)).

- The programme provides for a monitoring of public finances, which should ensure convergence towards the objective of public debt not be more than 60% of GDP as fixed in the Maastricht treaty. It is inspired by the so-called debt-break in the German constitution, which sets a ceiling for public debt from local level via federal state level to the federal level.
- The package also provides for a set of gradual sanctions, including fines (the latter only for member states of the Euro zone) in the area of public finance.
- Decisions should be taken according to a new 'Reversed Qualified Majority Voting mechanism.' Under this rule, which would apply when imposing sanctions, a European Commission proposal would be considered adopted unless the Council overturns it by a qualified majority.

The European Parliament, who postponed on 21 June its agreement with the Council of Finance Ministers on the package, wanted an automatic mechanism of sanctions without any voting but the Council did not agree with that proposal. The vote to legally adopt the 'six pack' on 6-7 July did not take place.

The 'six pack' is the result of a compromise that had been reached bilaterally between France and Germany (see [Newsletter nr. 5](#)). While Berlin had always opposed a coordination of the economic policies in the Euro zone, France has been advocating an economic government. However, under the pressure of the crisis in the Euro zone, Merkel finally accepted a step towards coordination of fiscal policies as well as a proposal to address macroeconomic imbalances inside the EU. But the reverse side was, that Berlin imposed a strictly neo-liberal approach to economic coordination. As it was setting fiscal discipline as its top priority, all other parameters such as growth, employment, social welfare etc. were subordinated to what they considered to be 'sound fiscal policies.'

To rectify the macroeconomic imbalances, the package does not foresee real sanctions such as fines. The measures are only 'soft law', political peer-group pressure without enforcement. Germany's trade and current account surplus – as well as those of the Netherlands and Austria – will therefore not be questioned seriously, although the background of the proposals on macroeconomic imbalances was meant to tackle the excessive trade surplus of Germany vis à vis its partners in the EU and the large divergences in competitiveness by different Euro zone member countries.

Trade unions, left-wing parties and social movements are continuing to oppose this type of European integration. The European Trade Union Confederation (ETUC) commented on the package [as follows](#): "The ETUC will never support this kind of economic governance. Attacking wages and the labour market and slashing the welfare state is not the solution. On the contrary, this is likely to paralyse the scope for recovery and to exacerbate unemployment and insecurity." The [ETUC called](#) for the clauses to safeguard wages and collective bargaining, as introduced by the EP, to be maintained and strengthened.

^ photo by bbaunach: <http://www.flickr.com/photos/bbaunach/>

EU falling behind US in REGULATING DERIVATIVES: first EP vote on EMIR

On 5 July 2011 the European Parliament voted on a draft legal text for the European Market Infrastructure Regulation (EMIR). EMIR will deal with some of the problems in the [derivatives](#) market, but fails to fundamentally call a halt to this 'financial casino.' It is another step in the process that was described by [previous Newsletters](#) about the [over-the-counter \(OTC\) derivatives](#). EMIR attempts to deal with a major problem that arose before and during the financial crisis in 2007-2008, namely that nobody knew who was trading what kind of risky financial products with whom. This lack of transparency was especially the case for OTC derivatives that were traded as private deals (hence the 'over the counter') and not on public exchanges. Not only was the OTC derivatives market non-transparent, it was highly interlinked and for the most part not secured against default. This resulted in banks refusing to lend to other banks and to companies and aggravated the financial crisis in 2008-2009. However, the OTC market grew again after the crisis and the business reached \$601 trillion by the end of December 2010 (notional amount outstanding).



The Council of ministers of finance still has to decide on its position on EMIR but did not discuss the issue during the Council meeting of 12 July 2011. After the Council reaches an agreement the EP and Council will negotiate a compromise. The G20 has agreed that many OTC derivatives should be cleared by the end of 2012.

Decision making process

As announced in [a previous newsletter](#), the Economic and Monetary Affairs Committee (ECON) of the European Parliament (EP) voted on the EMIR text on 24 May 2011. The main elements were that most OTC derivatives would be reported to the authorities to improve transparency, and that more financial speculation should be insured against default. However, the text still had quite some loopholes, e.g. regarding full transparency (see also below) and protection against financial instability. The financial lobby had succeeded to water down the legislation on some issues while the ECON strengthened some points in comparison with the EC's proposal, e.g. regarding the publication of meaningful and regular information to the public. The EMIR decision-making process was heavily being lobbied by the financial industry because the OTC derivatives business is an important source of income for big (investment) banks and institutional investors, and related to high bonuses. [A civil society campaign](#) urging for imposing limits on how much can be speculated with food derivatives resulted in 14,000 e-letters to ECON members most of whom, however, failed to meet the request. Nevertheless, the ECON agreed on a new paragraph in the preamble that called on the European Commission to introduce regulation against speculation on food prices in the next legislation on derivatives (MiFID: see below).

The EP decided not to wait until it could agree with the Council of Finance Ministers, who have to co-decide, (fearing that it would be weaker or much delayed) before voting in Plenary on EMIR. However, in a special procedure, the Plenary voted on 5 July on its text of EMIR but not the accompanying 'resolution' that is required to finalise the EP's decision making process in 'first reading.' This provides an opportunity for the Council to still come to an agreement first among the Ministers of Finance, and then come to a compromise with the EP on a final EMIR text. However, in June, the Finance Ministers were still divided, e.g. on how much power should be given to the European Securities and Markets Authority (ESMA) and not to national supervisors, and the text was still quite different of that of the EP, e.g. no mentioning of reporting to the public. It was not clear how long the Council would take to come to an agreement since the Euro crisis was dominating their agenda.

Overall characteristics of EMIR as voted by the EP plenary

EMIR contains the following elements to make OTC derivatives more transparent and safer:

Reporting

- All derivatives trade, i.e. OTC and non-OTC as well as [cleared](#) and non-cleared OTC derivatives will need to be reported to a 'trade repository.'
- Trade repositories are commercial data base services that are strictly regulated by EMIR so that authorities can always access the information.
- Information in a meaningful way shall be made available weekly by the trade repositories or by supervisory authorities after ESMA has defined the criteria and way of publication

Clearing

In order to guarantee that payments are done by both the contracting 'counter parties,' a clearing house, or 'central counterparty' (CCP) can be put in between so that the CCP is party to both counterparties. In case one counter party cannot pay, the CCP has to make the payment or make other arrangements so as to make sure the contract continues or is being paid. The CCP requires a sum from the counterparties that serves as collateral in case of non-payment. This collateral ('margin' in jargon) can change daily according to changing risks of default and is often seen as a cost by the counterparties and thus avoided.

EMIR is about ensuring that many more OTC derivatives are being cleared, amongst others by clearing those derivatives contracts that have a standard format or by making more derivatives standardized and easy to understand.

- The EU supervisory authority (ESMA) has to identify those derivatives that need to be cleared.
- Financial counterparties such as investment banks and hedge funds will be compelled to clear those OTC derivatives that ESMA has identified as eligible for clearing.
- OTC derivatives traded by producers or end-users (such as food processing companies), who are defined as 'non-financial counterparties' in EMIR, do not have an obligation to clear for their hedging activities that are related to their commercial physical commodity activity. However, they also are obliged to clear above a certain threshold for other derivatives they trade.
- If a derivative cannot be cleared, other measures are to be taken to avoid the risk of default (by paying collateral) and other risks.
- Third country CCPs can be allowed to clear derivatives of European entities given that they are similar to European CCPs.

Loopholes

The text as voted in the EP plenary still has many weaknesses and loopholes, such as:

- Pension funds can be exempted from clearing their OTC hedging derivatives trade for 3 years, or more, and foreign exchange swaps can also be exempted.
- Many important technical details of the implementation of EMIR still need to be developed and proposed by the European Securities and Markets Authority (ESMA) in the period after EMIR is agreed by the EP and the Council. 'Market participants' are to be consulted by ESMA in that process and can thus weaken the implementation details. An amendment to also consult 'non-market participants' was not accepted during the EP plenary vote.

- The European Commission has to adopt the ESMA proposals, a process that can still be influenced by the financial industry (resulting in weak implementation) as well as the European Parliament (assumed to result in strong implementation).
- 'Non-financial counterparties' in EMIR do not have an obligation to clear their hedging activities that are related to their commercial activity. However, above a certain threshold they are obliged to clear other derivatives they trade.
- The definition of 'non-financial counterparties' used for producers or end-users (such as agricultural trading or food processing companies) and their derivatives trading might be insufficient to cover all financial and speculative characteristics of their trading and thus lead to abuse of the clearing exemption.

Weaknesses

- The objective was to make the derivatives market safer. However, the current draft legal text may lead to financial instability and a financial crisis. If many OTC derivatives are to be cleared through CCPs while there are no limits on how big CCPs can become and CCPs accumulate financial risks. The EMIR does include many risk-containment, management or organisational requirements for CCPs, such as the creation of a default fund. It remains to be seen whether sufficient CCPs will be created by commercial actors. There is no guarantee how many of the OTC derivatives will be cleared, and ultimately be traded on exchanges.
- The objective was not to shrink the OTC market as much as possible while it is covering many risky, speculative and destabilising elements such as foreign exchange derivatives that can speculate against a country's currency and the Euro (!), credit derivatives such as credit default swaps which are playing an important role in the Euro crisis and played an important role in the 2007-2009 financial crisis. No limits are being imposed on how much OTC derivatives can be traded overall.
- What's more, no limits are being imposed on how many OTC derivatives can be traded per counterparty or per type of derivative. This request by civil society through campaigns and the email action before 24 May has not been integrated into the EMIR text. However, in the preamble of EMIR the EP included an explicit call to the EC to propose in the next legislation position limits and other measures to address the problem of food price volatility. This means that EMIR does not have special measures to prevent OTC derivatives from being involved in food price speculation.
- The capacity of the supervisory authorities, especially at EU level, to follow through all their responsibilities in the massive derivatives market is not guaranteed.

Upcoming legislative proposals

The next legislative proposals that will deal with derivatives will review the Markets in Financial Instruments Directive ([MiFID](#)) and Market Abuse Directive (MAD), which the EC says will deal with food derivatives speculation. The date at which the EC's proposals for MiFID and MAD will be presented, has been delayed and is now expected to be end of September – beginning of October 2011.

The EC is subject to intense lobbying from the financial industry for instance to limit the increase in (pre-trade) transparency requirements and especially not to impose ex-ante (pre-established) legally binding individual and aggregate position limits. Such position limits have been openly opposed by the government of the UK. The EC is reportedly intending to propose position limits that are 'managed' by the supervisory authorities, i.e. implemented when supervisory authorities decide position limits are needed – a process which can be subject to huge lobbying.

G20 Agri ministers failed to address food price volatility and speculation



The G20 agricultural ministers met on 22-23 June 2011 in Paris to discuss how to tackle food price volatility and its impact on people. They decided to formulate an [Action Plan on Food Price Volatility and Agriculture](#). The declaration addresses to a certain extent several important issues related to global food security but has left the regulation of food speculation in the commodity derivatives markets to the Finance Ministers and regulators. In contrast, it has also promoted more use of derivatives by developing countries. The World Bank and JP Morgan have launched a food price derivatives programme for developing countries just before

the G20 Agricultural Ministers conference.

At the beginning of June 2011, an Interagency Report '[Price Volatility in Food and Agricultural Markets: Policy Responses](#)' was published after being commissioned by the G20 and written jointly by FAO, IFAD, IMF, OECD, UNCTAD, WFP, the World Bank, the WTO, [IFPRI](#) and the [UN High-Level Task Force on the Global Food Security Crisis \(HLTF\)](#). Even though the report focused on dealing with the consequences of volatility, it also made an assessment of speculation in financial commodities markets, identifying arguments for both its positive and negative effects. It recommended higher transparency and appropriate rules for the [futures](#) and [over-the-counter derivatives](#) markets, paying attention to the 'need for harmonization across exchanges' to avoid that speculators would concentrate in the least regulated markets ('regulatory arbitrage'). It also listed policy options (without making explicit recommendations), such as limiting position held by speculators on commodity futures contracts, limits on daily price changes, limiting commodity reserves held by financial parties to avoid abuse. Furthermore it lists measures to deal with high volume and high frequency food commodity derivatives trading, and the option of global commodity futures contracts with compulsory delivery (see report, paragraphs 88 and 89).

G20 Ministers took only small decisions

The G20 Agricultural Ministers met on 22-23 June in Paris to discuss how to tackle food price volatility and its impact on people. They decided to formulate an [Action Plan on Food Price Volatility and Agriculture](#). Like the Interagency Report, the Action Plan focuses on agricultural issues, such as improving agricultural production and productivity, better market information and transparency in the physical markets, international policy coordination, and reducing the effects of price volatility for the most vulnerable, for instance by building up food reserves.

Only a short chapter is dedicated to regulation of financial commodity markets. The ministers recognised that appropriately regulated and transparent agriculture financial markets are a 'key for well-functioning physical markets.' They established a new Agricultural Market Information System (AMIS) so that improved information about the state of physical markets would also benefit the derivatives markets. They urged for a 'better collaboration between authorities, regulators and bodies responsible for agriculture physical and financial markets to improve supervision.' However, the Agricultural Ministers did not call for any particular measure themselves. They referred to the forthcoming work of the International Organization of Securities Commissions (IOSCO) to ensure better functioning and more transparent agricultural financial derivatives markets, to prevent and address market abuses and cross-market manipulations between physical and financial markets, and disorderly markets. The Agriculture Ministers strongly encouraged the Finance Ministers and Central Bank Governors to take the appropriate decisions for a better regulation and supervision of agricultural financial markets, supporting the G20 [Financial Ministers' conclusions from 14-15 April 2011](#). These conclusions included the "need for participants on commodity derivatives markets to be subject to appropriate regulation and supervision," such as through formalised powers to authorities to "manage" positions of

derivatives traders and “set ex-ante position limits where appropriate.”

In other words, the Agricultural Ministers ignored many ideas from the Interagency Report and failed to make any clear and strong recommendation on financial commodity derivatives markets themselves and left the issue of derivatives markets regulation solely to the Finance Ministers and regulators. This leaves an important aspect of safeguarding global food security in the hands of Finance Ministers and financial experts only. This is in stark contrast with the [speech of President Sarkozy on 14 June 2011](#) at the European Commission’s [conference on challenges and price volatility in commodity and raw material markets](#), where he denounced speculation in food and other commodity prices by financial speculators. The EU ministers had also declared the need for appropriate regulation and supervision to tackle commodity price volatility and potential abuse by market participants in a [declaration on 23 May 2011 ‘on financial challenges on raw materials and in commodity markets’](#). All these conferences and declarations have not prevented [food prices to rise again in June 2011 according to the FAO](#).

Clear NGO demands and critiques

An ad hoc coalition of NGOs had received an opportunity on 12 May 2011 to [officially address one preparatory meeting for the G20 agricultural ministerial meeting](#). On 12 June, NGOs met the French minister of agriculture Bruno Le Maire and warned that the G20 had not done enough about the real causes of food insecurity and that the agreement’s scope would be too remote from the emergency of the situation. They insisted on strengthening and better coordinating national and regional food stocks, controlling fluctuations in agricultural prices. To address the ministers’ meeting, several NGOs had launched a [petition](#) with the slogan ‘Don’t gamble with our food,’ amongst others calling for tackling speculation. NGOs also protested at the meeting (see [video](#): On 20 June, 250 people participated in a picnic organised by Peuples Solidaires – Action Aid, ATTAC, Artisans du monde and Confédération Paysanne (after some of them occupied the Euronext office) to once again [put pressure on the Agriculture G20 meeting](#). The weak outcome of the G20 Agricultural Ministers meeting was condemned by [the coalition of French NGOs](#), and by [Oxfam France](#) amongst others.

In other G20 countries, discussions also took place on the same issues, such as in Germany. In early June 2011, the German Ministry of Agriculture released a position paper on price volatility. It is mainly pointing to fundamentals as the driving force in price volatility and the role of financial markets is seen as rather unclear. Accordingly, the paper calls for more transparency but is rather cautious regarding any further measures such as price and position limits. The German parliament held a hearing ‘Prevent Speculation with Agricultural Commodities’ on 27 June 2011. While some testimonials, that of the German farmers for example, were rather open to speculation on agricultural markets, others, such as UNCTAD or WEED, warned against the financialisation of agricultural markets. The written testimonial by WEED can be found [here \(German\)](#). The hearing also was accompanied by a [photo stunt by Oxfam, Misereor and WEED](#).

World Bank, JP Morgan jointly launch a food price risk management product

Developing risk management tools was part of the discussions by the agriculture ministers of the G20 at their conference in Paris. Before the G20 conference, a document was commissioned and circulated about how to increase the use of commodity hedging by developing countries. The G20 agriculture ministers welcomed the facilitation and increased use of agricultural commodity derivatives through the World Bank Group’s new Agriculture Price Risk Management (APRM) product. Such a derivatives product was launched jointly with US investment bank JP Morgan (see [press release](#)). In practice the World Bank’s International Finance Corporation (IFC) and JP Morgan will each commit up to \$200 million in credit to farmers and other private clients to hedge against volatility of agricultural commodity prices. JP Morgan, one of the world’s largest dealers in commodity derivatives, would offer simple hedging instruments. Potential clients may include agricultural producers, consumers, cooperatives, governments and local banks as well as others that meet predetermined requirements in developing countries. According to the World Bank, this would provide ‘up to an initial \$4 billion in protection from volatile food prices’ for farmers, food producers, and consumers in developing countries. Price stability is seen as vital to help producers gain access to finance and to increase farm production and food supplies for

consumers. The World Bank wants to get other banks involved as lenders in its Agriculture Price Risk Management product in order to provide credit in countries with emerging economies as well as in lower income countries (Sub-Saharan Africa, North Africa, the Middle East); To those who would not normally be able to pay for hedging.

The G20 concern about the malfunctioning of derivative markets, that is recognised as contributing to excessive commodity price volatility, contrasts with its promotion of instruments that result in more hedging through the use of agricultural commodity derivatives whose markets are still not well regulated and supervised. More financialisation of commodities markets and more hedging by actors from developing countries has been condemned by many civil society organisations and farmers' organisations that favour family farming as not solving any fundamental problems. The fact that JP Morgan has a strong and self-serving interest in promoting derivatives products raises further concerns.

Publications

[UNCTAD, Price Formation in Financialized Commodity Markets, June 2011](#)

[M. Henn, 'The speculator's bread', April 2011](#)

[IATP, G-20 agriculture ministers meet in Paris with little result, June 2011](#)

[WEED \(ed.\), Evidence on Negative Impacts of Commodity Speculation by Scientists, Analysts and Public Institutions](#)

Stop Gambling on Food & Hunger - *Call for Immediate Action on Financial Speculation on Food Commodities* ([statement signed by more than 100 organisations](#))

EU Commission in Favour of Financial Transaction Tax (FTT)

In June 2011, the European Commission spoke out in favour of an FTT at European level and announced it would propose a Directive thereto in Autumn 2011. Civil society, who has struggled to achieve this for years, considered this a surprising breakthrough for the idea of an FTT concept and welcomed some elements of the EU proposal. However, there are still considerable weaknesses into the Commission's proposal, such as a tax base that is too small. The most tricky issue of the EU proposal is that the revenues would not be spent directly on anti-poverty or sustainability measures but would be allocated to the general EU budget – which would bring about a key change in the power relation between the EU and its member states.



That the European Commission (EC) spoke out in June 2011 in favour of an FTT at European level was quite a surprising turn in the long and controversial debate on the Financial Transaction Tax (FTT). This brought the FTT nearer to implementation than ever before and is a great success for the proponents of the FTT, in particular civil society who organised a [global day of action on 22 June 2011](#).

Although Tax Commissioner Semeta was still opposing a European FTT during the first months of 2011 and in spite of a staff paper from August 2010, which was also speaking out against the FTT, the president of the Commission, Barroso, has officially launched the idea of an European

FTT in letters to the European Council heads of state in June 2011. Barroso – as well as Semeta – have confirmed the proposal in several interviews. Barroso [announced](#) to the European Council that the Commission would present a directive for a financial transaction tax ‘that could be collected at EU level’ in the autumn of 2011. The European Parliament has no decision making power over European tax matters but already [expressed its support for an FTT at EU level in March 2011](#).

France, Germany and Austria had already pushed for the FTT for over a year. As a result, the Council decided that the EC would make an impact assessment of both the FTT and the IMF’s idea of a Financial Activities Tax (FAT). The difference between a FAT and FTT is that a FAT taxes the salaries of the management and the employees working in the financial industry, while the FTT is taxing financial transactions, generates substantially more revenues and can work against speculation. The publication of the EC’s impact assessment is expected for this summer. The June statements of the EC are already using the basic elements of the EC’s assessment.

The cornerstones of the EC proposal

1. Both the FTT and the FAT are feasible at the European level, but priority is given to the FTT. Although an FTT at global level would be desirable, the EU should play a vanguard role and not wait for the G20.
2. The tax base is suggested to be:
 - a. shares
 - b. bonds
 - c. derivatives on shares and bonds
3. The tax rate should be split:
 - a. 0.1% on shares and bonds.
 - b. 0.01% on the derivatives mentioned under point 2c.
4. As for the derivatives, the tax base should be the nominal value of the underlying assets. This means, the tax rate refers to the value of the shares or the bonds and not to the price of the option or other derivative, which might be only something in the neighbourhood of 3% of the value of the underlying asset. For instance, trading an option which allows to sell a package of shares with a notional value of €1 million next September, would yield €100 in tax revenues.
5. The income of the FTT at EU level is estimated at more than €30 billion. In case currency transactions are included, the amount could be more than €50 billion.
6. The place where the tax should be levied is not the trading place, but the fiscal residence of the seller of an asset (‘country of origin principle’). This allows the identification of the origin of a deal, which is important for legal reasons.
7. The revenues from the tax should go to the general EU budget.

Light and shadow of the proposal

The EC proposes that the tax rate for transactions in shares and bonds should be double of what civil society, academia (e.g. [S. Schulmeister](#)) and others had been discussing (0.1% instead of 0.05%). This was a positive surprise for campaigners of the FTT who have heard so many objections to many of their proposals over the last years. Equally positive is that the nominal value is taken for the derivatives. The EC staff paper in August 2010 (mentioned above) was still sceptical about such an approach. With the ‘country of origin’ principle the Commission is also adopting a proposal from civil society.

The shadow side, however, is that the tax base is too narrow:

- a. Currency trade is completely excluded.
- b. Only a very small fraction of derivatives – exchange traded derivatives of shares and bonds – is included. The bulk of derivatives trade would fall through the cracks, in

particular the entire over-the-counter trade, which is around 90% of the derivatives' market.

This limited tax base reduces the regulatory effect of the tax and the amount of the revenues.

Use of the money – a tricky issue

The most tricky issue, however, is the use of the revenue from the tax. The commission wants the revenue for its own general EU budget. There is no mention of use for development and environment purposes. In other words, the Commission intends to use the FTT as a Trojan Horse to strengthen its own position vis à vis the member states. A tax under the control of the EU would be both a historic and structurally intrusive change. The right to levy taxes is, besides the monopoly of violence through police, army etc, the second important pillar of statehood. Giving the right to the EU to levy its own tax would mean a significant transfer of sovereignty from the national states to the supra-national level. It would also require a change of the EU treaties.

This is why this element of the proposal has already been qualified as 'dead on arrival.' Several governments, among them Germany and the UK have declared that they would not accept an EU tax. Also among civil society the allocation of the revenues directly to the EU is much criticised because the EU integration process is biased towards neo-liberal policies and the interests of big business rather than giving priority towards a social and sustainable Europe and democratisation. At the national level, there are still more means to influence the use of the FTT revenues than at the EU level.

Barroso knows, of course, that his proposal is not feasible in the foreseeable future. He is using it as a bargaining chip in the negotiations on the EU budget, which are taking place at the same time. The challenge for civil society then is to use the momentum of the EC proposal for the FTT without getting lost in the 'Bermuda triangle' of battles between the EC, the European Parliament and the Council over EU structures and budget negotiations.

The lesson of the FTT campaigning so far has been, once again, that in politics, at the end of the day, pressure and the political balance of power are the decisive factors for decision-making.

Banks in the spot light

During the turmoil on European financial markets and in the Euro zone, European banks who are holding bonds of countries that needed bail out packages to deal with their huge budget deficits, have also been attacked by the financial markets. In order to provide investors and financial markets with the confidence that banks have enough capital reserves to withstand financial and economic turmoil, the supervisory authorities organised a stress test of the 90 biggest European banks. After fierce debates, the stress test results were published on 15 July 2011. In the meantime, the EU and international banking standard setting bodies are working on regulations to make higher capital reserves mandatory for banks, and even more so for systemically important banks.



Stress test of banks: stressed out

In order to provide investors, governments and financial markets a better insight in the strengths and weaknesses of banks in the EU, especially in the case of a deep financial and economic crisis, national and European supervisors organised a 'stress test' and The results of the 'stress test' of 90 large banks in the EU were published on Friday 15 July 2011. The results show that 8

banks (5 Spanish banks, 2 Greek banks', one Austrian and one German bank, mostly banks not listed on the stock exchange) did not succeed in the test and were having too little capital reserves to withstand very negative economic and financial circumstances. The top three banks coming out of the test are BBVA (Sp), Intesa (It) and ING (NL). However, this bank stress test has once again been accused of not sufficiently dealing with all possible doom scenario's, including a major default on Greek bonds that are held by banks.

Before the stress test was published, fierce debates were already blazing for various reasons. The results of the stress test of European banks had been very weak in 2010 – the Irish banks had passed the test but collapsed shortly after. In 2011, there was a lot of pressure to ensure the basis of the calculations would make the test more credible, for instance by taking into account a potential default by Greece on its bonds. The ability of European banks to absorb losses in case the Greek bonds are not repaid in full, is an important aspect in the June-July discussions to come to an agreement at EU level for a second bailout package for Greece (see other for article in this Newsletter: [Dramatic climax of the Euro crisis while financial market reforms are delayed](#)). Nervousness at the banks was also caused by the fact that the test will reveal how much more capital banks will be forced to raise, which could affect the share prices and new requirements being imposed on banks. When the European Banking Authority (EBA), which is responsible for the test, required the banks to make recalculation on some of their valuations at a very late stage, this evoked angry responses from the banks. However, since the national authorities had left it to the banks to do their own tests, the first tests were based on assumptions that did not take into account possible doom scenarios. German banks were angry that the standardised valuation requests did not take the specifics of their banks and of German regulation into account, so that the test would put them at a disadvantage. Prior to the outcome of the stress test, several banks had increased their capital buffers and undertaken some restructuring but it nevertheless became clear that some banks would fail. Discussions also arose about how much capital reserve would be considered appropriate. In the context of the Euro crisis and the unresolved problems of Greece, Portugal, Ireland and Italy, the question arose whether the stress test would indeed bolster confidence in the banks, as was its original purpose, or instead create more financial instability.

In order to deal with banks that have failed the stress test, the EU Finance Ministers decided on a coordinated strategy for promptly dealing with 'vulnerable' banks that failed the test, which would include private sector and governmental support. All countries will need to have 'backstop mechanisms' in place at the time of the results of the stress test, which will be monitored thereafter, such as:

- A three-month period for banks to present a clear plan to address vulnerabilities and a maximum of six months to implement the necessary remediation.
- A broad range of measures, including both private and public instruments, such as external audits, additional reporting requirements, reinforced monitoring, capital increases, risk-mitigating actions, restructuring, sale or transfer of assets, splitting of core and non-core activities, merging of banks where appropriate, and the orderly winding down of banks.
- In case of need for more capital, private-sector solutions will be preferred and the use of public funds only available as a last resort, subject to strict conditionality.
- Exchange of information and consultation among competent authorities of cross border EU banks.

Implementing Basel III: race to the top or to the bottom?

The stress test in 2011 was so important because last year's Basle III agreement adopted by the central bankers of the Basle Committee on Banking Supervision (BCBS) and the G20 heads of state, has still not been implemented (see previous Newsletter nr 6 [Reforming the banks: still a long way to go](#)). Indeed, one lesson learned in the financial crisis is that banks should have

higher capital buffers to absorb losses. The European Commission is still working on a legislative proposal to implement at Basel III, which is already referred to as in its Capital Requirements Directive IV (CRD 4) but which the EC has announced in June to be a regulation (CRR 4), which has a swifter implementation process. Even before its publication, expected before the end of the summer 2011, already fierce discussions took place. For instance, plans to undo the 'minimum-requirement'-character of Basel, and thereby limit the freedom of national regulators to set higher capital ratios for their own banks, met with fierce resistance from a number of Member States, [led by the UK](#).

The BCBS pointed to the need of a strict implementation of Basel III in all countries, warning for "a competitive race to the bottom". This competitive race now seems to be under way with the [EU and US criticizing each other](#) over lowering the standards for implementing Basel III.

The EC is also working on a legislative proposal on how to deal with banks in crisis so that they can be winded down if need be (see paragraph on failing banks in Newsletter nr 6 article on [Reforming the banks: still a long way to go](#),

The central bankers of the Basel Committee on Banking Supervision (BCBS) are still discussing how much more capital so called Systemically Important Financial Institutions (SIFI's) should hold. The extra capital reserve required is expected to be around 2% for the most risky and biggest banks. As announced in its most recent [progress report on the implementation of G20 recommendations for strengthening financial stability, the Financial Stability Board](#) (FSB), in consultation with the BCBS, will recommend by the G20 Summit in November 2011 an additional degree of loss absorbency for globally systemic banks (G-SIFI's) and the instruments by which this can be met. Whether or not a bank is a G-SIFI depends on its score on five criteria: global activity, size, interconnectedness, substitutability, and complexity.

^ photo by [Cesar Pics](#)

Calendar

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](#)

2011

July

- **21, Brussels:** possible meeting of the Eurozone Heads of State or Government to agree on bail-out package for Greece.

September

- **?, Madrid (IOSCO):** recommendations on regulation and supervision of agricultural commodity derivatives
- **9-10, Marseille (G7):** Ministers of Finance meeting planned to focus on currency issues

- **12-15, Strasbourg:** EP plenary meeting
- **13, Brussels (European Council):** meeting of Heads of State or Government
- **19, Brussels (ECON):** meeting
- **20, Brussels (EP, Greens/EFA):** conference “Beyond Basel III - Towards a resilient EU banking sector” (subscribe before 8 September with philippe.lamberts@europarl.europa.eu)
- **22, Brussels (ECON):** meeting
- **23-26, Washington:** possible meeting of G20 Finance and Development Ministers on financial reforms related to development issues
- **25 -27, France (G20):** Ministers of Labour meet on “Work and Employment”
- **End September, ? (G20):** meeting by Sherpa's to prepare G20 summit

October

- **? October, Brussels (EC):** publication of proposal for the review of the Capital Requirement Directive (CRD 4/CRR 4) to implement Basel III and the proposal for a bank crisis management framework.
- **4, Brussels (ECOFIN):** meeting
- **11, Brussels (ECON):** meeting
- **14-15 or 16, Paris (G20):** meeting of the G20 Ministers of Finance and Central Bankers expected to put the finishing touches on the economic reform agenda before G20 Summit
- **Mid October, Brussels (EC):** publication expected of the review of the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive (MAD)
- **17-18, Brussels (European Council):** meeting of the Heads of State and Government
- **17, Brussels (ECON):** meeting

November

- **?, Brussels (EC):** publication of an impact assessment on potential new financial sector taxes
- **?, Brussels (EC):** publication on proposal to reform credit rating agencies
- **1-3, Cannes, France (NGOs):** scheduled alternative people's summit
- **2, Nice, France (G20):** social G20 conference
- **2-4, Cannes, France (G20):** heads of state summit
- **5 November (G20):** Mexico takes over G20 presidency
- **7, Brussels (ECON):** meeting
- **8, Brussels (ECOFIN):** meeting
- **18, Brussels (ECOFIN):** meeting
- **29, Brussels (ECON):** meeting
- **30, Brussels (ECOFIN):** meeting

December

- **9, Brussels (European Council):** meeting

2012

January

- Danish Presidency starts six-month Council Presidency

April

- **21-26, Doha (Qatar):** [UNCTAD XIII
<http://www.unctad.org/Templates/meeting.asp?intlItemID=3375&lang=1&m=21643&info=highlights>]

June

- **4-6, Rio (UN):** [Rio +20 conference](#)

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