Stichting Onderzoek Multinationale Ondernemingen
Centre for Research on Multinational Corporations

How European Financial Sector Reforms affect Developing Countries

Draft Discussion Paper

Myriam Vander Stichele

November 2010- updated March 2011

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Colophon

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Content

1. Introduction and summary

This discussion paper is a draft. After the Seoul G20 Summit this discussion paper will be completed and finalised.

The financial crisis which erupted in the Europe in 2008 and the ensuing economic crisis had severe consequences for many developing countries. For instance, bank credit for trade dried up which badly hit income from trade by developing countries. Since 2008, the European Union (EU) has started to reform its financial sector to prevent a new crisis. However, it still needs to be fully analysed whether the way the EU is designing and implementing its financial reforms could also have negative consequences for developing countries. This report is part of a project[1] that intends to ensure that the interests of developing countries as well as sustainable development are taken into account when the EU decides on its series of financial sector reforms. By critically analysing major EU financial sector reforms, this report especially aims at identifying where developing country interests and sustainability are at stake, what concerns need to be raised and what remedies could prevent potential problems. The follow-up activities planned under the project include a process to further discuss the concerns raised in this report, and to popularise them with recommendations for change. By exploring potential negative consequences of new EU financial sector laws, the reports does not attempt to provide a full overview of the positive and negative impacts of these laws.

Given the vast number of financial sector reforms that have already been decided on and are still in the pipeline at the EU level, the issues in this report are a selection, made on the basis of perceived importance and potential for change. The report[2] "Fixing Global Finance" by Indian expert Kavaljit Singh was used as a background document and is recommended reading to understand the issues discussed in this report.

The major concerns and potential negative consequences for developing countries which this report has analysed and identified can be summarised as follows:

In chapter 2 which covers **banking reforms**, the report identifies how supervisors from developing countries in which European banks operate will have little say in the new European supervisory system. New banking regulations, which the EU has already endorsed or will decide on in 2011, might increase the profit maximisation strategies of European banks and insufficiently reduce risky behaviour. This might reduce credit and services by European banks operating in developing countries if no changes are made in the business models of those European banks or in the planned EU legislation.

Chapter 3 assesses the EU reforms of **financial markets** and their participants, whose behaviour has a significant impact on developing countries.
Credit Rating Agencies (CRAs) can greatly affect how much developing countries have to pay for loans. This report claims that their huge influence and enormous mistakes, which contributed to the financial crisis, will not end unless the EU effects fundamental changes in the CRA market. The proposals for such fundamental changes made by the European Commission (EC) would benefit crucially from proposals to reduce the costs of high quality ratings for developing countries and develop alternative ratings or rating agencies.

1 For more information about the project "Towards a Global Finance System at the Service of Sustainable Development", see: http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms
2 The report can be downloaded at: http://somo.nl/news-en/fixing-global-finance/

Trade in agricultural and other commodity derivatives greatly affects the prices of these products imported and exported by developing countries. To avoid negative impacts, the report proposes how further derivative market reform that is planned by the EC needs to be much stricter than the first timid legislative proposals already on the table.
The new legislation that regulates **hedge funds and private equity**, decided on in November 2010, is judged ineffective to prevent their speculative and harmful behaviour in developing countries.

In Chapter 4, the report embarks on a discussion of the flawed **EU decision making process** that undermines swift and thorough financial reform and keeps the interests of the EU financial industry of paramount importance. The report explains how unregulated financial speculators exploited the EU's unsound monetary and economic governance, so contributing ruthlessly to the financial, economic and Euro crisis. The report proposes that a Financial Transaction Tax (FTT) should be introduced at EU or Euro-zone level in order to finance the budgetary gaps caused by the crisis and to meet the needs of developing countries.

In the final chapter, the report reveals the diverse ways in which the EU and a few EU member states make decisions in **international fora** on financial reforms enacted upon at EU level. The EU still needs to develop its position on issues that are important for developing countries and were hotly debated at the Seoul G20 Summit (November 2010), such as a stable international currency regime, the use of capital controls and how to avoid global trade and budgetary imbalances. The report indicates how the EU continues to negotiate in the same way as before the financial crisis free trade agreements that liberalise those financial products and operators that are currently being reformed. The report warns that the disciplines imposed on governments by these agreements can undermine financial reforms.

Overall, the report concludes that the EU financial reforms do not go beyond preventing the worse instability and riskiness of the financial sector. While developing countries benefit from a more stable European financial system, they would also benefit from a vision by the EU that the financial industry should be at the service of a sustainable society, not only in the EU but also in developing countries. As before the financial crisis, the decision-making process on EU financial sector laws is hampered by conflicts among member states about the competitiveness of their financial industry based on neo-liberal models some of which are incorporated in the Lisbon Treaty (e.g. free movement of financial services and free movement of capital).

There is a huge need for diverse, alternative and developing-country voices to be heard EU's decision-making process on the reforms… to which this report hopes to contribute.

For the reader who is not familiar with all the issues and technical terms in this report, the SOMO-WEED Newsletter on EU financial reforms, and other SOMO and WEED reports might be of interest.[3] A glossary in the Annex explains many technical terms used in this report.

[3] http://www.weed-online.org/themen/english/index.html; http://somo.nl/dossiers-en/sectors/financial/financial

2. Reforms of the banking sector and its supervision

2.1 The European banking sector and developing countries

Some large cross-border banks and conglomerates headquartered in the EU ('home banks') have an extensive presence in many developing countries (see Table 1). In several developing countries, foreign banks have a market share of more than 50% - making the countries very dependent on and vulnerable to the stability of those foreign banks. Banks headquartered in the EU have a high presence in some particular developing countries, for example in Latin America is host to many Spanish banks.

Table 1: Amount of subsidiaries/branches in developing countries of 10 EU-based banks, March 2010

Bank	Amount of subsidiaries/branches in developing countries
HSBC (UK)	38
BNP Paribas (F)	35
Credit Agricole (F)	33
Barclays (UK)	25
Deutsche Bank (Germ)	20
Unicredit (It)	18
ING (NL)	17
RBS (UK)	17
Santander (SP)	9
ABN Amro (NL)	7

Source: SOMO, March 2010: own calculations based on publicly available information from the listed EU based cross-border banks which were chosen on the basis of a) an extensive international network, b) a significant market share in the home country and c) headquarters in a Member State of the EU.

Before the financial crisis, the acquisitions by and presence of foreign banks in developing countries was generally promoted by policy-makers who argued that foreign banks increase the efficiency of the banking system in those countries. However, just before the crisis, there was also a growing recognition of various negative impacts of foreign banks, as revealed by research by academics[4] and by civil society organisations[5]. For instance, foreign banks in particular countries tend to provide less credit than domestic banks, provide no or little financial services to small farmers, rural customers, the poor or small companies, and focus their services on profitable rich clients.

The financial crisis revealed the dangers and vulnerabilities of foreign banks operating in developing countries. Developing countries were affected by foreign banks operating in their country, including European banks or conglomerates, as follows:

- Withdrawal of capital from subsidiaries or branches in developing countries to the headquarters (or other foreign parts) of internationally operating banks.
- No, little or expensive credit for trade activities (export-import) or (small) enterprises in the host country.

[4] N. van Horen, Foreign Banking in Emerging Markets, presentation at SOMO Expert meeting EU financial reforms, 26 May 2010.
[5] K. Singh, M. Vander Stichele, Rethinking liberalisation of banking services under the India-EU free trade agreement, SOMO, September 2009

- Selling of subsidiaries or branches in developing countries by the parent bank to meet its need for more capital.
- Instability at foreign bank operations in developing countries due to failing supervision and regulation in the home country and at the international level. Some of these host countries had committed themselves in trade agreements to opening their markets to foreign banks permanently without guarantee of good supervision and regulation of the home bank.
- Rescue packages to bail out banks did not guarantee that capital would also be transferred equally to parts of the bank outside the home country, including to developing countries. It is possible that the bailouts were issued with hidden conditions of more credit to be given to SMEs in the home country at the expense of credit in host countries.
- Foreign banks that were bailed out competed unfairly with domestic banks of developing countries who did not have the capacity to bail out their banks.

Given the links between European cross-border banks and developing countries, and the negative impacts of (European) banking crises on developing countries, it is important that the EU takes into account those impacts when introducing new banking legislation.

2.1.1 Supervision

The financial crisis revealed that not only the regulation of cross-border banks and financial conglomerates was insufficient, but also supervision was inadequate. In addition, there were too few mechanisms to make home and many host supervisors cooperate and share information when managing a failing EU based cross-border bank or financial conglomerate.

The EU agreed in 2009 and 2010 to improved supervisory structures. Without aiming to present a comprehensive analysis of the general pros and cons of the new European System of Financial Supervisors within the scope of this paper, the participation of supervisors from developing countries is discussed below regarding:

- Colleges of bank supervisors
- European Banking Authority (EBA)
- European Systemic Risk Board (ESRB)

Colleges of bank supervisors: no guaranteed access by supervisors from developing countries

Colleges of bank supervisors, which are bodies of supervisors from the home and the host countries of the same cross-border bank that has its headquarters in the EU. Colleges of supervisors were strengthened and their functioning improved by the first review of the EU's Capital Requirement Directive (CRD) in September 2009, which resulted in the so-called CRD 2.[6] The review imposed improved cooperation within each college of supervisors to supervise and prevent the risks of cross-border banks.

In order to implement the functioning of the colleges of supervisors as regulated in CRD 2, the Committee of European Banking Supervisors (CEBS) has developed "Guidelines for the Operational Functioning of Colleges"[7] – such CEBS guidelines of Directives are a normal procedure in the EU. According to CRD 2[8] and the CEBS guidelines, host supervisors of countries that are not part of the

[6] The official code of the reviewed Directive is : 2009/111/EC
[7] CEBS, Guidelines for the Operational Functioning of Colleges, June 2010, http://www.c-ebs.org/documents/Publications/Standards---Guidelines/2010/Colleges/CollegeGuidelines.aspx
[8] See especially Art. 42a, 129 and 131,

EU or the European Economic Area (EEA)[9] "may" become part of the college of supervisors of a particular cross-border EU bank operating in their country, "where appropriate". In practice, the home supervisor is the one deciding whether a developing country supervisor becomes member of a college of supervisors of a cross-border bank that operates in that developing country, based on several criteria such as:

- Favourable advice from the college supervisors from the EU and EEA;
- The significance and risks of the subsidiary in that country for the cross-border bank as a whole;
- Confidentiality requirements.

These criteria do not include the significance of the subsidiary or branch of an EU based bank in developing countries regarding its role in that developing country, e.g. in the payment systems and savings. This contrasts with the criteria used for admitting EEA host supervisors and the advice given by the Basel Committee of Banking Supervision.[10] This means that the operations of a subsidiary or branch of a European bank in a developing country can have an important impact, but that the host supervisor cannot participate in the cross-border supervisory decisions which might affect the country concerned, for example when a crisis situation occurs, or regarding the risk assessment model used by the bank.

Once a host supervisor from a developing country is admitted to a college of supervisors, that supervisor will receive all relevant information but might not always be able to participate in the meetings. Firstly, the CEBS guidelines allow that not all college supervisors participate in some college meetings that deal with particular issues. Also, no financial or human resource support is being provided for developing countries. Nevertheless, home supervisors are advised to include all important host supervisors in information sharing.[11]

Disputes among supervisors

There are circumstances in which home and host supervisors do not agree, for instance because the decision by the home supervisor would result in less credit being provided in a host country. It is a very sensitive issue who takes the final decision in case of disagreement, because the decision of the home supervisor might be beneficial for the home country but not for the host country/ies, and vice versa. In September 2010, the EU introduced new legislation on supervision by which such disputes can no longer be resolved by the decision of the home supervisor alone. The newly created European Banking Authority (EBA) has received the mandate to make binding final decisions, after a mediation period, in case of disputes among supervisors of a college. However, this procedure is based on disputes among EU supervisors. EBA can make a binding decision to be implemented by national supervisors in EU member states, or if they fail, binding directly to the relevant cross-border EU bank itself.
Given that no third country supervisor is part of EBA, and that not all supervisors from developing countries in which an EU based cross-border bank plays an important role, might be part of the college (see above) there is no guarantee that disagreements from supervisors of developing countries will be resolved sufficiently and in a way that protects all the interests of that developing country.

EBA is allowed to develop contacts and enter into administrative arrangements with supervisors and administrations from non EU countries and international organisations. How many contacts and

[9] EU countries and Iceland, Liechtenstein and Norway.
[10] Basel Committee of Banking Supervision, Good practice principles on supervisory colleges, October 2010, p. 5 (under principle 2): "In determining appropriate sub-structures the materiality of the banking group in the host jurisdiction(s) should also be considered", http://www.bis.org/publ/bcbs177.pdf
[11] Basel Committee of Banking Supervision, Financial Stability Board, Good practice principles on supervisory colleges, October 2010, Annex 1.

arrangements will be developed with developing countries remains to be seen, given the limited financial resources provided to all the supervisory bodies.[12]

European Systemic Risk Board (ESRB)

A newly created European Systemic Risk Board (ESRB)[13] was created in order to assess and warn about systemic risks building up in the financial system. The ESRB has no power to act in case of a system risk. The definition of systemic risks is being interpreted as posing problems to the financial stability and economy in the EU.
The ESRB has an Advisory Scientific Committee, whose chairs participate in the high level meetings of the ESRB[14]: this could provide an opportunity to include one or more supervisors or experts from a developing country.

Main concerns, missing issues and recommendations

The new EU supervisory structures have been designed with insufficient consideration to avoiding the negative consequences of risks created by EU based cross-border banks, and decisions made by their supervisors, in those developing countries where such banks play a (significant) role. The newly agreed EU rules on colleges of supervisors of EU based cross-border banks will not provide sufficient improvement of the deficient arrangements between home and host supervisors in developing countries, which already existed before the crisis.[15]

What is missing is a mandate that supervisors should assess all new financial products and practices designed, sold and used by banks, for their impact on financial stability and social usefulness ("a financial product safety authority"). Financial innovation has been a major cause of the recent financial crisis and supervisors did not even monitor or assess new products or practices. Many developing countries have problems assessing new complex financial products and practices introduced by foreign banks, and more responsibility of the home supervisors regarding the worldwide impact of financial innovation would prevent that problematic innovative products and practices are being introduced in financial markets. In general, all financial innovations which are judged to have negative consequences and to be too complex to be understood should be banned.

The following recommendations might improve the functioning of the new EU banking supervision:

- When assessing the functioning and composition of a college of supervisors of a particular EU based cross-border bank, the home supervisor and EBA should ensure that all supervisors from developing countries in which that bank plays a significant role in the domestic financial system, can participate in the college of supervisors through an invitation to participate, provision of financial resources and the implementation of the necessary information sharing arrangements.
- EBA should ensure that when taking binding decisions to resolve disputes among the supervisors of a college, the interests of developing countries where an EU based bank plays a (significant) role, are taken into account.

[12] SOMO WEED Newsletter – EU financial reforms, Issue nr. 3, October 2010, http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/october-2010/renderTextHTML?footer_url=http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/october-2010/xxx

[13] For more information about the ESRB, see SOMO WEED Newsletter – EU financial reforms, Issue nr. 1, 2 and 3 (April, June, October 2010).

[14] For more information about the ESRB, see among others: http://www.europarl.europa.eu/en/pressroom/content/20100921IPR83190; and http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2010-0335+0+DOC+XML+V0//EN&language=EN: see Art. 11a

[15] See for instance such as arrangements as the "Concordat" agreed by the Basel Committee on Banking Supervision.

- The upcoming review of supervision of financial conglomerates to improve supervision of banking, insurance and trading or asset management activities by one (international) firm, should ensure full participation of the relevant supervisors of those developing countries where the particular conglomerate plays a significant role. The review started in August 2010[16] and will be decided on by the European Parliament[17] and the Council of Finance Ministers in 2011.
- The ESRB should redefine the definition of systemic risks to also cover risks for society (e.g. the gap between rich and poor, the poor having no access to financial services, too little credit for sustainable agricultural activities and too much lending to financial speculative activities and products, too much credit for environmentally harmful projects and companies, etc.).
- In the ESRB, supervisors and/or high level experts from large and some small developing countries should be given a seat in the Advisory Scientific Committee.
- Overall, new mechanisms should be designed to make supervisors of all levels accountable to parliaments, especially after major problems of their functioning have emerged during the financial crisis, and to the public at large because mistakes in supervision can lead to spending huge amounts of tax payers' money as well as have severe impacts on all countries where the supervised banks are operating.

2.1.2. New banking rules in the EU

A major instrument to control banks has been to regulate how much capital a bank must reserve to be able to deal with defaults from borrowers and from activities on financial markets (e.g. trading in shares, bonds, derivatives). The international standards about capital requirements are set by the Basel Committee on Banking Supervision and are called Basel II, Basel II also includes rules about how to assess the risks of borrowers (and of other credit provisions), how banks should be supervised and how they are to provide information to supervisors and the public/investors. The Capital Requirements Directive (CRD) is the EU law that has made Basel II legally compulsory for EU banks.

Quite a number of developing countries have encouraged or required their domestic banks to implement the complex and wide-ranging rules of Basel II, which has been costly for these banks, as well as for their supervisors. All EU based banks operating in developing countries should in principle have implemented Basel II and apply the same risk management system in all host countries (a practice that seems not always to be the case).
During the financial crisis, EU based banks and other foreign banks withdrew capital from their affiliates and branches based in developing countries. This resulted among others in less credit provided to trading and other companies in the host developing countries.

2.1.2.1. Banking rules that the EU has already reviewed

Because the financial crisis has clearly shown that Basel II has deficiencies, some changes made in Basel II have been incorporated in reviews of the CRD at EU level: CRD 2 and CRD3 have already been agreed on at EU level in 2009 and 2010 respectively, which resulted in improved regulation regarding:

- Reducing risky (re-)securitisation by banks – securitisation was a major cause of the financial crisis due to non-transparent mechanisms and complex products whereby banks were selling off dodgy loans, e.g. sub-prime, to others in order to avoid capital requirements

[16] For more information about the proposal by the EC, see : http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/376&format=HTML&aged=0&language=EN&guiLanguage=en

[17] In October 2010, the planned dates for the decision making process at the European Parliament were: Draft for consideration: January 2011; amendments: February 2011; vote in Committee: 21 March; vote in plenary: May 2011.

- More capital requirements and transparency about risks by banks that are holding securitised products.
- Limits to inter-bank lending because to reduce dependency by banks on each for access to their daily working capital.
- Strict regulation against excessive remuneration and bonuses of bank staff, a practice which is considered to have provided the wrong incentives, favouring the short term risky bank behaviour that caused the financial crisis.
- Improved risk assessments of speculative and risky activities on financial markets (e.g. derivative trading) and higher capital reserves to be used in case of defaults.

The newly imposed rules on selling and buying (re-)securitised products will somewhat reduce the risks by banks to the financial system. However, they are insufficient to fully stop the risky practices and the off-balance related activities. The proposed measures do not provide the opportunity for the host country supervisors, when they would be aware of risky securitisation practices of the parent company elsewhere than in a host country, to stop the parent bank from doing in cases that entail high risks for the whole of the bank.

When regulating the excessive remuneration and bonuses, the EU has failed to tackle the underlying principle of the current private banking system, i.e. maximisation of profits - a major cause of the high-risk activity that caused the financial crisis. Maximisation of profits has been taking place even at the expense of the social functions of banking, including in developing countries where European and other foreign banks are more interested in serving very rich clients than poor customers.

It is not clear what the impact of limiting inter-bank lending will be on developing countries: will the EU prefer to lend to other Western banks and provide less lending to developing countries? Or will less concentration of inter-bank lending in the EU lead to more lending to banks in booming economies, which might be done even if it requires taking more risks? It would be useful if EU regulators or supervisors would assess the impact on host developing countries annually.

2.1.2.2. Basel III and CRD 4: higher capital requirements

The Basel Committee on Banking Supervision (BCBS) has agreed on new rules, which are called Basel III. They complement and add to, but do not fully replace, Basel II rules. They go beyond the issue of capital requirements.

The chief elements of Basel III[18]:

- More and better quality of capital (namely retained earnings and equity), which banks hold as reserves against unexpected losses from loans.
- More capital reserves to be built in good times for use in bad times.
- A new standard for how much liquidity (capital that is easily converted into cash) banks hold.
- Increased capital requirements for loans that finance trade in derivatives and securities.
- A limit on the extent to which banks themselves can borrow and use derivatives (‘leverage ratio’).

After the G20 approval of the Basel III proposals in November 2010, and the final detailed proposals by the by the BCBS were published in December 2010[19], the EU is planning to start the process of

[18] See SOMO-WEED Newsletter, - EU financial reforms, Issue nr 3, October 2010.

[19] See BCBS, Basel III rules text and results of the quantitative impact study issued by the Basel Committee, Press release, 16 December 2010, <http://www.bis.org/press/p101216.htm>

incorporating the new Basel III standards in EU legislation before the end of the Summer 2011. It is not clear yet whether the EU will implement all Basel III rules. Doubts have been expressed by cooperative banks that Basel III will reduce the possibility to maintain diversity in the banking system. Such diversity is needed to create alternatives to the current banking system.

The European banks have already warned that they will suffer many negative consequences due to the high and costly requirements. They argue that their lending to small and medium enterprises will decrease. When EU based cross-border banks will indeed have problems to re-capitalise, this might affect developing countries if these banks resort to practices that diminish lending to small and medium enterprises in all the countries in which they are present, or if these banks will focus even more on rich clients in developing countries. Supervisors should have a clear mandate to avoid negative consequences (see below: chapter 2).

In case Basel III will make EU based banks sell off some less profitable subsidiaries or branches in developing countries, this can cause problems in case the buyer has even lower quality corporate governance or is not well supervised. Currently, there is an increase of banks from emerging markets and other developing countries becoming active abroad[20], whose supervisory quality might be lower than in EU countries. On the other hand, in order to re-capitalise, European banks are in search of expanding in highly profitable (emerging) market countries, such as India, including through acquisitions. This will be encouraged by the fact that Basel III will allow high quality capital held by banks to include “minority interests”, i.e. shares from (developing) country banks in which the buying bank has no majority of the voting or control of the management. However, given the record of foreign banks’ practices, more of their presence might result in less credit or fewer financial services for the poorer domestic customers.

Regarding the higher capital required to cover risks from lending to traders in derivatives and securities, it is important that lending for bilaterally non-transparent ‘over-the- counter’ (OTC) traded derivatives (see below: derivatives markets) as well as banks’ own activities in these markets meet higher capital requirements. However, the proposed requirements will still not be high enough to restrict or even halt loans to speculative traders in financial markets which have negative consequences for developing countries, societies and the environment, such as:

- Financial speculative trading in all commodity derivatives whose speculation results in commodity price volatility and high prices for poor food importing countries (see also below).
- Trading in derivatives that are based on CO_2 emission allowances (carbon trading) and projects for offsetting CO_2 emissions (see below).
- Hedge funds which heavily speculate in commodity derivative trading and other speculative activities using huge borrowed sums from banks (high leverage). The strong relation between banks and risky hedge funds (who are also active in developing countries: see below) is not sufficiently tackled by the new capital requirements although many banks that needed to be bailed out had strong financial links with hedge funds.

[20] N. van Horen, Foreign Banking in Emerging Markets, presentation at SOMO Expert meeting EU financial reforms, 26 May 2010.

Table 2: The relationships between banks that were bailed out and hedge funds (HFs)

			Total	Services to HFs by bailed banks			
Bailed Company	**Bailout Date**	**Bailout Country**	**Services to HFs**	**Prime Broker**	**Custodian**	**Investment Advisor**	**Other**
AIG	16/09/2008	US	119	13	22	48	36
Allied Irish Bank	11/02/2009	Ireland	77	1	25	4	47
American Express	09/06/2009	US	26	-	5	16	5
Bank of America	28/10/2008	US	851	481	342	17	10
Bank of Ireland	11/02/2009	Ireland	117	11	69	3	34
Bank of New York Mellon	28/10/2008	US	624	44	232	74	268
BNP Paribas	20/10/2008	France	419	36	230	28	119
Boston Private Fin.	21/11/2008	US	4	-	4	-	-
Capital One Financial	14/11/2008	US	2	-	2	-	-
Citigroup	28/10/2008	US	982	226	225	18	507
City National	21/11/2008	US	2	-	2	-	-
Comerica	14/11/2008	US	99	7	92	-	-
Commerce N. Bank	09/06/2009	US	2	-	2	-	-
Commerzbank AB	01/11/2008	Germany	37	10	22	1	3
Credit Agricole	20/10/2008	France	309	9	69	142	73
Dexia	30/09/2008	Belgium	297	19	117	66	88
Fortis	29/09/2009	Belgium	1173	78	480	54	559
Goldman Sachs	28/10/2008	US	2025	1052	731	9	229
JP Morgan Chase	28/10/2008	US	1691	680	747	61	197
Lloyds TSB	13/10/2008	UK	3	-	3	-	-
Mercantile Bank	15/05/2009	US	1	-	1	-	-
Morgan Stanley	28/10/2008	US	1938	1130	764	6	37
Northern Trust	14/11/2008	US	350	34	112	-	204
PNC Financial S.G.	31/12/2008	US	458	8	119	6	321
Royal Bank of Scotland	13/10/2008	UK	65	3	-	9	-
Société Générale	20/10/2008	France	500	-	30	9	25
State Street	28/10/2008	US	262	15	122	20	104
Sun Trust Banks	14/11/2008	US	8	-	8	-	-
Swedbank	04/11/2008	Sweden	15	1	8	4	2
U. S. Bancorp	14/11/2008	US	9	1	8	-	-
UBS	16/10/2008	Switzerland	1075	443	298	92	215
Wells Fargo	28/10/2008	US	35	3	24	4	-
WestLB	01/01/2008	Germany	4	-	-	4	-
Country Totals		Belgium	1470	97	597	120	647
		France	809	9	99	151	98
		Germany	41	10	22	5	3
		Ireland	194	12	94	7	81
		Sweden	15	1	8	4	2
		Switzerland	1075	443	298	92	215
		UK	68	3	3	9	0
		US	9493	3694	3564	279	1918
Grand Total			**13584**	**4305**	**4915**	**695**	**3083**

Source: Robert W. Faff, Jerry T. Parwada and Kian Tan, "Were Bank Bailouts Effective during the 2007-2009 Financial Crisis? Evidence from Counterparty Risk in the Global Hedge Fund Industry," February 12, 2010: cited by K. Singh, Fixing Global Finance, Madhyam-SOMO, October 2010, p. 50-51.

Main concerns, missing issues and recommendations

The overall approach taken by the new capital requirements and EU directives is that they mainly aim only to avoid financial risks and financial instability that can affect the functioning of the financial system and the economy. This might indeed reduce instability and excessive risks taken by banks with worldwide impacts, including in developing countries. However, no attempt has been made to ensure that the banking system is socially efficient, i.e. able to meet the financial needs of society, of those who are most in need of loans, to engender transformation towards more environmentally and socially sustainable economies.

What is missing in the reforms by the Basel Committee and the reviews of the Capital Requirements Directives is a complete overhaul of the risks assessment systems used by many European banks. Basel II allowed banks to use their own internal risks assessment models, which resulted among others in risky lending. However, most of all, these internal risk assessment models failed to sufficiently weigh social and environmental risks when assessing loans, and provided no incentives for lending to socially and environmentally friendly projects, companies, trading or consumption.

What is also missing are measures, beyond limiting bonuses, that would tackle banks strategies on how to maximise profits that continue to be the main driving force of banks and which lead to risky behaviour. For instance, if the new capital rules will reduce lending to SMEs and poorer clients, including in developing countries where EU banks are operating, it will be necessary for the EU to implement measures to encourage banks to change their business models and become less profit but more service oriented. Before the financial crisis, many European cross-border banks had billions of Euros in yearly profits.

In order to improve the new banking rules when enacting new EU legislation through CRD 4, the following recommendations need to be taken into account:

- When the EC carries out an impact assessment of the potential impacts of its legislative proposals for CRD 4, it needs to include assessment of the effects in developing countries of the new rules imposed on EU based banks operating in developing countries. Also, the EC should fully assess the impact of the capital requirements on society and the environment in all its aspects.
- Since developing countries have expressed concerns that the new capital requirements are not appropriate for their banking system and might be unnecessarily costly to implement and supervise, EU regulators and supervisors should allow developing countries to have sufficiently flexibility and policy leeway to implement Basel III according to their own needs. Indeed, although the Basel Committee on Banking Supervision now includes all G20 members, many developing countries still have no say in the decision making of Basel III. Therefore, the EU should stop requiring that developing countries, with whom it signs free trade agreements that liberalise financial services, fully adopt Basel II or Basel III standards. Rather, the EU should provide international support for optimal regulation and capital requirements in developing countries. New standards should not restrict the creation of diverse and new (well managed and supervised) banks in developing countries.
- The EU should forbid (“Volcker rule”) propriety trading, whereby the bank is trading in risky and speculative financial markets on its own risk and with its own money. This would provide more guarantee that banks active in developing countries are not involved in overly risky activities which, in case of severe problems, would result in the bank becoming very unstable. If such instability would result in a run on the bank, in the home countries or in one or more host counties, and a bankruptcy would follow, money from savers in developing countries would be lost.
- In the negotiations under the General Agreement on Trade in Services (GATS) (see also below), the EU should not request to eliminate domestic laws in host countries, which require

that some adequate capital reserves should remain in the host country (and not be held at international level which banks consider less costly). The financial crisis has shown that parent banks withdraw capital from their foreign operations in time of crisis, which has negative effects on host countries (e.g. less credit provision). EU regulators and supervisors should ensure sufficient measures are in place to avoid capital flight from developing countries to EU bank headquarters in times of crisis.

- The EU should introduce precise guidelines for responsible lending, at least in order to avoid loans being provided to very poor customers and poor countries in an unethical way – resulting in no-repayable debt – and resold to world wide financial markets (securitisation).
- The EU's CRD 4 should reduce the current high capital requirements for small cooperative and ethical banks regarding non risky but socially and environmentally friendly activities. This should allow the creation of more diversity and alternative banking in the current banking system. This would be preferable to the current development of more identical and concentrated banking systems due to the current banking standards.

Overall, the new banking rules planned in the EU (in March 2010: CRD 4) might somewhat reduce risks at EU based cross-border banks but could lead to less services and credit in developing countries. At the same time, some supervisors in developing countries could have little say in the college of supervisors of the bank that operates in their country in order to reverse negative the impacts.

3. Financial markets: hardly tamed

This chapter covers reforms in those financial markets and their participants which have already proven to have an important impact in developing countries:

- credit rating agencies,
- derivatives markets, and
- hedge funds and private equity funds.

3.1. The crucial role of credit rating agencies (CRAs)

The great extent to which banks and other creditors, as well as investors, speculators and even supervisors, use private commercial credit rating agencies (CRAs) to assess the creditworthiness and value of companies, government bonds, financial products, etc, is often underestimated. The ratings issued by these agencies determine levels of credit, interest rates (cost of borrowing), and capital reserves or other risk mitigation mechanisms. Many financial operators and investors lack the capacity to carry out their own full risk assessments and rely too easily on CRA ratings.

However, time and again, CRAs have failed to adequately assess the risks of borrowers and financial products. This was the case before the current financial crisis, when complex securitised mortgage products were incorrectly given high quality ratings, which facilitated the sale of these risky products all over the world. CRAs are also frequently accused of lagging behind the market, rather than take a leading role. For example, during the 1997 Asian Financial Crisis, countries were rapidly downgraded during the crisis. Had they been downgraded prior to the crisis, i.e. in a period of market calm rather than widespread panic, the fallout may have been less severe. Furthermore, empirical modelling by the Nobel Laureate, Jo Stiglitz, suggests that, in comparison to the rating implied by fundamentals, ratings were excessively high and low before and after the crisis respectively. This suggests that CRA ratings methodologies were biased and incomplete. This is not acceptable in general, but is particularly indefensible when one is dealing with sovereign debt from developing countries. Capital rapidly flows out of a developing country after a ratings downgrade. This is highly destabilising. In a similar vein, inflated ratings may lead to a credit bubble.

CRAs are not currently legally liable for their ratings in many European countries, as they are "opinions". This is despite the fact that ratings have been incorporated into capital adequacy requirements by governments around the world. One reason for incorrect ratings is that the credit rating industry suffers from conflicts of interest and a culture of high bonuses. The credit rating industry currently deploys an “issuer-pays” business model that is riddled with perverse incentives. As the issuers of debt products pay for the products to be rated, they may shop around to see which CRA will give their debt the highest rating (reflecting the lowest estimated risk of default), as this will translate into the lowest cost of borrowing. This gives CRAs an incentive to inflate ratings and thus maximise their chances of winning commissions. A generous rating today may help ensure that CRA is contracted to rate any future products that entity issues.

The use of credit ratings is often incorporated in legislation, for instance to determine what kind of financial products an institutional investor or insurance company can hold. Basel II standards, for instance, require that banks that have not developed their own risk assessment mechanisms have to use the so-called standardised approach and have to select credit rating agencies based on strict selection criteria (which are set by Basel II). Many developing country banks still use the standardised approach.

Credit ratings are important for developing countries because they help cut through the shroud of ignorance that clouds western views of the developing world. Many investors are simply not aware that there are good business opportunities in developing countries. The CRA rating of the creditworthiness of a developing country has important consequences for the cost of borrowing: the lower the grade, the higher the interest rate a developing country or a company needs to pay for a loan from a credit institution, or the higher the level of interest (coupon) that a developing country needs to pay when issuing a bond. Companies and regions within a developing country are affected by the sovereign rating through the so-called 'sovereign ceiling'. This means that they can rarely obtain a better rating than their sovereign, independently of their real creditworthiness. CRAs often do not rate (smaller) developing country companies that cannot pay the high rating fees. This results in difficulties for these countries to obtain reasonable access to finance via credit, the stock market or institutional investors. CRAs have influence on the developing countries' economic policies through the threat of being downgraded, which leads some governments to reinforce their investor-friendly free market policies rather than indigenous less free market oriented but efficient policies. This is especially true in times of crisis, or if other countries are already being downgraded. Thus, CRA ratings influence how much capital flows from creditors and investors to developing countries and their companies or citizens, and can thus influence the destiny of a whole country.

There are various other problems with ratings by CRAs of developing countries and companies in those countries. The CRA ratings of developing countries are often of a lower quality because these agencies often devote less staff for rating developing countries' bonds. Moreover, although CRAs have a wide range of indicators in their rating catalogue, ratings are often determined by a few indicators, with GDP per capita, growth rates and inflation being the most important. Though CRAs have adopted their rating methodologies after the Asian crisis, this limited number of criteria makes it difficult to foresee a crisis.

Generally, the indicators used by CRAs have favoured procyclical ratings that were enthusiastic in times of booms and then quickly decreased in times of recession, thus intensifing the country's problem in the crisis.

Nevertheless, CRAs remained unregulated until after the eruption of the recent financial crisis. In 2009, the EU adopted new Regulations to impose certain conduct on CRAs, which became fully applicable in December 2010, requiring that CRAs:

- need to apply for registration (and only registered CRAs can be used by European firms);
- are regulated in their business conduct and have to avoid conflict of interest;
- are more publicly transparent about their rating methodology and record;
- have to be regulated also if they are based outside the EU.

At the end of 2010, additional changes to the CRA regulation were adopted[21] to ensure efficient and centralised supervision of CRAs at a European level through the European Securities and Market Authority (ESMA) and to ensure that all CRAs have access to the same information.

Since Spring 2010, sharp and sudden downgrading of ratings of EU member states by CRAs due to high indebtedness (Greece, Ireland, Portugal, Spain) resulted in these countries having to pay very high interest rates for loans and bonds. This action exacerbated the economic crisis and the Euro governance crisis, as well as speculation against the Euro. EU institutions have subsequently acknowledged that the CRA reforms in the EU were far from sufficient. CRA ratings often diverge from

[21] For more information, see: http://www.europarl.europa.eu/oeil/FindByProcnum.do?lang=2&procnum=COD/2010/0160

ratings of other financial institutions. Also, international standard setting bodies[22] are promoting improvement and less reliance on CRA ratings. New US regulation is even prohibiting banks to rely on CRA ratings.

In November 2010, as the start of a new legislative process, the European Commission (EC) launched a public consultation[23] about how to deal with the following remaining structural problems:

- over-reliance by banks and investors on CRA ratings, and lack of internal capacity to assess risks and creditworthiness/values;
- improving the rating methodologies used to rate government debt;
- concentration of complex ratings in the hands of a few large CRA agencies (3[24]) that have an affective oligopoly on the market, which stifles competition, quality and innovation, and which keeps prices high.;
- lack of an EU wide system to make CRAs liable for their mistakes;
- conflicts of interest because the rating of a financial product is paid by the issuer of that financial product.

The above issues represent just a small sample of the number of problems with CRAs, and fixing these issues will require an enormous restructuring of the rating industry and rating and credit worthiness assessments practices by banks, financial markets participants and investors.

Whatever improvement of CRAs, or development of alternative agencies or credit assessment practices occurs, it is likely to make rating and assessments more expensive. This could have a negative impact on developing countries if, for instance, governments or companies in developing countries are not able to pay the higher fees for rating or other assessment methods. The EU will need to take into account the needs of governments and companies in developing countries when proposing and enacting new solutions, including preventing inordinate costs for rating bonds and companies from developing countries.

Main concerns, missing issues and recommendations

So far, EU reforms have been limited, and have not guaranteed a more stable globalised financial sector. Only when these important areas (overreliance on a few CRAs, improving sovereign debt rating methodologies, lack of competition, lack of liability, conflicts of interest and high bonuses) are subjected to fundamental reform, will the credit rating industry operate as it should.

What is missing from the EU reform agenda so far is a discussion on how to ensure that CRAs and other creditworthiness assessments are able to correctly include all social and environmental risks with respect to borrowers and financial products. For instance, environmental damage such as the oil spill of BP or social unrest because human rights are breached around mines can have important consequences for the financial situation (e.g. capacity to repay loans) of a company, including reputational damage that can be hugely costly for a firm. Social and environmental assessments could provide incentives to invest more in sustainable companies and products.

In order for the EU to fully reform credit ratings and their agencies in a way that benefits developing countries as well as sustainable development world wide, the following points need to be covered:

[22] Financial Stability Board; see also activities by IOSCO (code of conduct for CRAs)
[23] See for more information: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1471&format=HTML&aged=0&language=EN&guiLanguage=en: the deadline for submitting comments is 7 January 2011.
[24] Fitch, Moody's, Standard & Poor's

- Take firm legislative steps on all the structural issues raised in the recent EC consultation. A large public debate would be far more effective than a discussion among lobbyists of the financial industry.
- Highly improve the quality of the ratings by those CRAs providing external ratings by further improving the methodology and process of rating (not only for sovereign debt) beyond what is already in the EU's Regulation on Credit Rating Agencies. Additional criteria should be imposed such as:
  - macro economic instability risks should be included;
  - CRAs should have excellent capacity to rate the social and environmental impacts. An example has already been set by China's Central Bank which has been promoting an environmental protection credit rating system. The bank will use environmental laws and a five-color rating system to rank environmental impact assessments. This information will be used to determine a project's eligibility for Chinese bank loans. Another example has been set by Züricher Kantonalbank.
  - CRAS need to more frequently review sovereign debt ratings and issue frequent warnings that the CRA is considering/moving towards an up- or downgrade.
- The criteria for choosing a CRA for external ratings when a bank uses the standardised approach should include the capacity of a CRA to integrate of environmental and social issues in the credit rating process.[25]
- Solutions should be based on commercial as well as public/governmental engagement, at national and international levels, and not only seek market-based solutions. CRA reform should ensure that all the costs of the borrowers are being incorporated and especially that no costs of financial products will be paid by society. Examples of how public and/or private initiatives could improve the ratings are:
  - Supervisors and Central Banks publish own ratings on all asset classes, so that they can be compared with those of commercial CRAs;
  - A European Credit Rating Agency (ECRA) could play an extremely important role in setting (a higher) standard in the market. It could take the form of an institute that is really independent from both governments and market participants, the form of a European Credit Rating Foundation, with funding from the financial services industry and/or governments, or a publicly funded ECRA;
  - a second CRA to rate in the process of the standardised rating approach, based on merit, is allocated by supervisors (which could diminish the possibility to 'shop' for the highest rating by the sellers of financial products but could also increase some concentration through specialisation).
- Developing countries governments and companies need access to high quality ratings and other assessments methods. If new high quality ratings increase assessment prices, solutions should be sought. For instance, independent, well-supervised and publicly funded agencies could be created e.g. the ECRA or European Credit Rating Foundation, or arrangements could be made whereby creditors and investors share the costs of the assessments (e.g. a programme helping developing countries get rated, which has already be done by the US Department of State, Bureau of African Affairs and the United Nations Development Programme). Therefore, in its impact assessment of proposals for new regulation of the Regulation on CRAs, the EC will need to assess the impact not only in the European markets but also on developing countries and assess scenario's of what mitigating or other measures would be the best to avoid negative impacts.

[25] This proposal was made in: BankTrack, Submission to the Basel Committee - Comments on the documents: "Strengthening the resilience of the banking sector" "International framework for liquidity risk measurement, standards and monitoring", 16 April 2010.

- Too high volatility of the ratings should be prohibited for instance by defining “gross negligence” e.g. when a sovereign, a company or a structured product is being sharply downgraded in a very short period of time. The principle of civil liability should be introduced at EU level when there is gross negligence by CRAs and when new standards for social and environmental assessments in ratings have not been respected and have negative effects on citizens. Based on a clear definition[26], gross negligence could be sanctioned by the supervisors and/or by the courts.
- In order to break the dominance and current over-reliance on the three large CRAs, the following measures could be taken:
  - to implement full competition policy, including clearly defining of abuse of dominance (e.g. regarding high fees) and restrictive business practices in the CRA market, and own investigations by competition authorities;
  - supervisors should publish an annual report whereby they are providing an assessment of all CRAs operating in the market, also the smaller ones;
  - All financial institutions and commercial entities should improve their capacity to do internal ratings and be less dependent on CRAs.
- Ensure that the EU supervisor of CRAs (ESMA) provides official channels through which developing country authorities and users of CRAs, as well as affected stakeholders (e.g. citizens from highly endebted countries), can submit complaints of CRA misconduct. In addition, the EU should ensure that ESMA has sufficient funds to adequately perform its supervisory duties.

3.2 Derivatives markets: speculation on food and currencies

Derivatives are contracts which place a bet on the change of value of the underlying products (commodities, currencies), events (e.g. increase in interest rates, default on a loan), etc.

Whilst derivatives can be used for purely hedging purposes (to transfer price risk to a market participant who is willing and able to bear this risk), they can also be used in a highly speculative manner. Derivatives permit gambling on price changes in a given market, without actually having to invest in that market, which would require a large outlay of cash. Thus, speculators can quickly build up an enormous exposure to a market, by putting down only a small amount of capital. The huge profits made in derivatives trading have resulted in the payment of high bonuses and more incentives to speculate. However, EU’s official view is that whilst derivatives trading exacerbated volatility in the financial markets, it did not cause the financial crisis, and is not a systemic risk.

Developing countries can be affected by derivative trading, as explained below, because commodity trading relates to the prices of many of the products they export or import, such as wheat, soy, maize and other food products; coffee, cocoa and other agricultural commodities; oil and gas; gold, tin and other metal commodities. Commodity derivative trading can also be based on carbon trading contracts and CO2 offsetting contracts, most of which relate to offsetting projects in developing countries.

Foreign exchange derivatives also affect the value of developing countries’ currencies: The instability of the value of foreign exchange of many countries throughout 2010 – which is discussed at the level of the G20 – influences, and is influenced by, speculation with foreign exchange derivatives (e.g. foreign exchange swaps).

[26] See our answer to question (1) above: e.g. when a CRA is sharply downgrading a financial product or sovereign debt during a very short period of time.

Around 10%[27] of the derivative market is used by firms or farmers who want to insure, or 'hedge', themselves against volatility in prices of products they need for their business (e.g. oil, commodities): Derivative contracts can guarantee these 'end users' get a given price for the underlying product. These hedging contracts are sold on to speculators and investors (approx. 90%) who are gambling on future movement of prices, events, etc. Some speculators then hedge again, to insure against the risks they are taking in other speculative derivative contracts. In June 2009, the overall worldwide real value of derivatives trading was estimated to be $21.6 trillion while the real risks were estimated at $3.7 trillion. The total value of all the contracts on which the derivatives are based was estimated to be $605 trillion.[28]

Derivatives are designed so that small changes in value can have huge effects on what the parties to the derivatives need to pay. Many traders also borrow money to finance their derivatives trade. Moreover, as derivatives are traded on such a large scale, they enormously increase the linkages between financial institutions, so that if one institution fails this can create a domino effect. Derivatives therefore can hugely contribute to the instability and volatility of the financial markets. For example, the financial crisis in 2008 was triggered when one variety of derivative (collateralised debt obligations-CDOs: see below), which had been widely sold, turned out to have been dramatically mispriced. Banks subsequently were afraid to lend to one another, as they didn't know which institutions had exposure to these now defunct derivatives. This created a 'credit crunch', which resulted in the credit flowing to the real, productive economy being cut off. Lehman Brothers collapsed as a result of this liquidity crisis. Many other large financial institutions that were exposed to CDOs or to financial firms with problematic CDOs, had to be bailout out by tax payers around the globe, as they were 'too-big-to-fail'.

Table 3: Value of the non-transparent OTC derivative markets, in notional amounts outstanding, December 2008

Major types of OTC derivative markets		Gross notional amounts outstanding, December 2008	Percentage
1. Credit derivatives:	includes CDS, CDOs,	$ 38.6 trillion	**7.4%**
2. Interest rate derivatives, of which:	Total	$ 418.6 trillion	**80.8%**
	Interest rate swaps	*$ 328.1 trillion*	
	Interest rate options	*$ 51.3 trillion*	
	Forward rate contracts	*$ 39.3 trillion*	
3. Equity derivatives	was $10 trillion in June 2008	$ 6.5 trillion	**1%**
4. Commodity derivatives	Includes: gas trading, base metals trading, power trading, crude oil trading, agriculture trading and emissions trading	$ 4.4 trillion	**0.8%**
5. Foreign exchange derivatives		$ 49.7 trillion	**9%**
TOTAL		**$ 517.8 trillion**	**99%**

Source: based on data from: EC, Commission staff working document accompanying the Commission communication - Ensuring efficient, safe and sound derivatives markets, 7 July 2009, chart 4 - OTC derivative market segments.

A major problem, also for developing countries, is that 90% of derivatives are traded bilaterally 'over the counter' (OTC) in non-transparent ways. This makes price movements difficult to analyse.

[27] Deutsche Bank Research, Current issues, 28 April 2010, p 5: based on figures from BIS, 2009
[28] Deutsche Bank Research, Current issues, 28 April 2010, p. 4.

Moreover, banks can hide some derivatives off their balance sheets. However, agricultural commodity derivatives trading occurs to a significant extent on exchanges, which report on prices and are used as price benchmarks by developing country importers and exporters, even though developing countries have no control over such exchanges (e.g. Chicago Mercantile Exchange).

OTC derivative trading expanded enormously after deregulation in the US (2000), and remained unregulated at EU level! No wonder that the financial crisis in the US started with two kinds of credit derivatives which were traded massively but made the wrong bets: Collateral debt obligations (CDOs) which packaged and sold overvalued sub-prime mortgages, and credit default swaps (CDS) which insured banks against defaults (of sub-prime mortgages) but made those who sold CDS bankrupt. Furthermore, in the Euro crisis in 2010, the value of CDS which were insuring Greek bonds were wrongly used as benchmarks for valuing Greek bonds while huge speculation in CDS was going on.

Even if commodity[29] and foreign exchange derivatives trade constitute a relatively small part of overall derivatives trading, its volatility and functioning can have serious consequences for developing countries:

- In the years leading up to mid 2008, many speculators had invested in commodity derivatives and related investment products (e.g. commodity index funds)[30], hoping to get higher profits than in other markets. Major commodity derivative speculators were a few investment banks (e.g. Goldman Sachs), hedge funds, other institutional investors such as pension funds, large agribusiness companies and other speculators. Huge price rises followed with a peak in June 2008 which resulted in food riots in 25 countries and millions more going hungry in food importing developing countries. Once the financial crisis broke out in September 2008, prices plummeted after financial speculators and investors in need of cash withdrew their money and economic forecasts were negative. But speculators and institutional investors came back again. Between January and September 2010 they poured "$18.3 billion into commodity offerings, versus $11.9 billion for the first nine months of 2009".[31] Hedge funds had increased their control of the soybean market to 19% in 2010, up from 13% in 2009, and controlled about 16% of the overall commodities markets. In 2010, some commodity prices were increasing again, such as soybean (14% since January 2010), and commodity derivatives markets, e.g. wheat, were very volatile, sometimes based on uncertainties and fundamental problems in production and delivery of the actual commodities. The manipulation of the cocoa derivative market by a hedge fund resulted in huge price increases in the summer of 2010 after which prices dropped again. In the beginning of 2011, the prices of many leading commodities were very high again, reaching the high levels of 2008. The experience so far has been that farmer incomes benefit little from price increases on agricultural commodity derivative markets but suffer badly from the volatility.
- Foreign exchange derivatives are being sold to exporters in developing countries, for instance by ABN Amro in India. Because the risks were not well explained and/or because of unexpected movements in foreign exchange, exporters in developing countries lost huge sums in recent years for instance in Brazil, as well as in India where some exporters in Tirupur[32] may well go bankrupt and make many workers unemployed. Different large or advanced developing countries have important derivative markets and some have committed to keep them open to foreign derivative traders and firms under free trade agreements, South Africa is one such example. India introduced foreign exchange derivatives in 2009.[33] If they are being used

[29] For more background information, see : T. Kerckhoffs, R. van Os, M. Vander Stichele, Financing Food, SOMO briefing, April 2010, <http://somo.nl/publications-nl/Publication_3471-nl/>
[30] Ibidem.
[31] IUF, UN Special Rapporteur on the Right to Food Calls for Measures to Limit Food Commodities Speculation, in News, 18 October 2010, http://cms.iuf.org/?q=node/552
[32] K. Singh, Fixing Global Finance, 2010, p 72-73.
[33] http://www.myfapturboforex.com/tag/growth-of-derivatives-market-in-india-2010/: namely currency futures

beyond hedging such (foreign) derivatives markets will result in more speculation and less capital being used for investment and or to leverage credit for the economy of those countries.

The start of an EU regulatory regime

Only in September 2010 did the European Commission (EC) present its first proposals[34] to regulate the derivatives market, which had since long been liberalised at EU level without EU regulation or supervision.

The main elements of the EC proposal to regulate OTC derivative markets are:

- Reporting all derivatives trade to supervisors to increase transparency.
- Attempting to reduce the risks associated with a counterparty defaulting on their payments, via making 'clearing' through central counterparties compulsory for all "eligible" OTC trades..[35]
- No obligations for hedging by so-called 'end-users' or 'non-financial parties'.
- Some details of the EC proposals have to be decided separately by the newly created EU regulators/supervisors (European Securities and Markets Authority, ESMA) which will also receive a mandate to supervise and intervene in times of turmoil.

The EC also made proposals, to tackle abusive practices in derivatives markets, especially with regards to CDS[36], and "(naked) short selling", i.e. selling a bond or stock that you do not actually own. The EC does not prohibit short selling but supervisors can intervene to ban short selling (in emergency situations). Also, naked short selling is *de facto* banned, more transparency is imposed and special measures will give particular attention to avoiding speculation against governmental bonds through CDS. The European Parliament already started its decision making process beginning 2011 with the intention to make strict regulation. EC plans to propose a revision of the Market Abuse Directive (MAD) in 2011 to create more mechanisms to avoid malpractices and manipulation.

Unfortunately, the EC's approach does not restrict what kinds of derivatives can be traded, for instance, financial speculation on food speculation is still permitted, as are socially useless and purely gambling derivatives. However, the EC is investigating the possibility of giving regulators the power to impose position limits on speculators in commodities markets.

Main concerns, missing issues and recommendations

The first proposals made by the EC to regulate OTC derivatives are very timid by allowing too many exceptions. They fall short of their own purpose of making OTC fully transparent and protected against high risks. Many fear that central counterparties are themselves likely to become 'too-big-to-fail' institutions. It is thus debatable whether the EC proposal will actually decrease or increase systemic risk.

What is missing is an approach whereby the EC does not limit the systemic risk in commodity markets only to the risk posed to financial systems but furthermore includes the wider ramifications, e.g. for food and energy supplies all over the world. The current approach fails to first assess if, or which parts

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[34] See also: SOMO-WEED Newsletter – EU financial reforms, Issue nr. 3, October 2010, http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-items/issue-3-october-2010/first-steps-in-eu-regulation-against-derivative-speculation

[35] In technical terms: introducing mechanisms that ensure and even oblige that more derivatives (especially 'standardised' OTC-derivatives) are cleared through central counter parties (CCPs). This means that CCPs ensure that financial buffers exist in case one of the two derivative contract holders defaults. CCPs will be strictly regulated. In addition, new risk mitigation techniques are to be applied to non-cleared OTC derivatives.

[36] This relates especially to speculating with CDS that insure against a default by a governmental bond without owning the bond: this happen with Greek bonds in 2010 and resulted in much higher prices for CDS which was followed by new Greek bonds having to pay higher interest rates to attract investors (but increased the burden on the Greek budget).

of the, derivative markets play a useful role for the economy and society, inside and outside the EU. Based on such an analysis, the conclusion might well be that all harmful speculative and socially useless derivative trading would need to be banned. According to experts, purely speculative derivatives trading is a zero sum game, with only traders and related service providers benefiting from high fees and bonuses. Thus, beyond hedging, and the degree of speculation needed to provide the liquidity for hedging, the existence of derivative trading remains highly questionable.

When proposing further legislation on derivatives, the EC should pay particular attention to commodity and foreign exchange derivative markets and incorporate the following recommendations, some of which have already been presented to the EC by civil society organizations and the UN Special Rapporteur on the right to food, who are concerned about the impact of (agricultural) commodity derivative speculation in developing countries:

- Introducing the precautionary principle in regulations to prevent rather than repair food commodity speculation and foreign exchange speculation.
- Adhering to the principle of no financial speculation in food, which in technical terms could be translated into:
  - well-defined and strict limits on, or bans of, financial speculative participants in (agricultural) commodity derivative markets
  - a strict definition for end-users who are hedging for their business;
  - a specific and strong capable supervisor for commodity derivative markets with close institutional links with supervisors and regulators of physical commodity markets, all having the capacity to intervene and stop excessive speculation and abusive practices;
  - a great increase in information about all commodity derivative trading, not only to supervisors but also to the public and developing countries authorities;
  - trading of all commodity derivatives on exchanges.
- Recognising that the prevention of abuse in huge, expanding, complex and extremely swift-moving derivatives markets by under-resourced supervisors[37] will be impossible and that it will be very difficult to ask for more financial resources to supervise speculation by the rich while governments are cutting budgets for social welfare.
- Providing mechanisms for developing country authorities and stakeholders to have access to supervisory bodies of derivative markets and to databases (“repositories”) on derivatives trading.
- Allowing countries to change the liberalisation of derivative trading that they committed to in trade agreements, and not including derivative trading liberalisation in future trade and investment agreements.
- Rethinking the functioning and usefulness of the hedging function of commodity derivatives and designing alternative financial insurance mechanisms against harmful price fluctuations.
- Dealing with the “fundamentals” and problems of (the financing of) production, storage, reserves and transport of commodities, as this would truly//help prevent disruptive events in commodity markets.

Overall, the EU decision making bodies should consult as much as possible with developing countries who are affected by (commodity and currency) derivative trading, and with civil society when designing and deciding on the new laws. For instance, if all commodity derivative trading would be on exchanges

[37] Art. First step towards new EU supervision finally taken, in SOMO-WEED Newsletter – EU financial reforms, Issue nr 3, October 2010, http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-items/issue-3-october-2010/first-step-towards-new-eu-supervision-finally-taken

and/or cleared, and the cost of hedging would be increased, ways should be found so as not transfer the burden of extra costs to poor commodity producers.

3.3 New regulation of hedge funds and private equity: poor benefits for developing countries?

Most EU authorities[38] argue that so-called 'alternative investment funds' (AIFs), such as hedge funds and private equity, did not cause the crisis, but aggravated it. Critics claim that hedge funds and private equity funds were fundamentally involved in the causes of the crisis as they are the main actors on speculative financial markets and financialisation of the economy, typically operating off-shore and completely in a non-transparent way: by producing very high returns, profits and bonuses, they were creating unrealistic expectations about high financial returns elsewhere in the financial markets and business world. AIF's huge investments, borrowing and connectness with the rest of the financial industry, were a very important causes of the financial crisis and accelerated the spread of the crisis in 2008.

For developing countries, AIFs are important because they become increasingly active in advanced developing countries where they are making high returns but also through their speculative activities, as is explained below.

Hedge funds are estimated to manage around €2 trillion in assets world wide in 2010. Although hedge funds only have 5-10% of assets managed by the global fund industry, their activities are associated with many risks and speculation, and viewed as contributing to the financial crisis, in various ways:

- Taking out far more loans than their own capital ("leverage") to finance their speculative strategies: these strategies were causing many problems when credit was lacking and returns on investments were down during the financial crisis.
- Accounting for over 50% of the daily trading volume in shares and stock markets.
- Using techniques that make them the drivers of prices on the global financial markets, easily contributing to asset and financial bubbles.
- Buying and speculating on securitised financial products like those based on sub-prime loans (CDOs), which triggered the financial crisis in 2007-2008: hedge funds had created and bought them heavily, and contributed to the market turbulence during the crisis.
- Their clients are wealthy individuals as well as pension funds and other institutional investors, who quickly withdraw money when profit expectations tumble – exacerbating crisis situations.
- Close relationships with large investment banks using their services and acting as counterparties to derivative deals.
- Using all kinds of tax evasion and avoidance mechanisms, for instance by being based in notorious tax havens.
- Increasingly taking on functions as intermediaries such as providing financing for large projects, offering exchange traded commodity funds, etc.

The impacts of hedge on developing countries are related to:

- Very active buying and speculating in derivatives markets, including agricultural commodity derivatives and related commodity index funds – contributing to price bubbles – and credit

[38] See for instance: European Commission, Working document of the commission services, Consultation paper on hedge funds, Staff document, 2008, http://ec.europa.eu/internal_market/consultations/docs/hedgefunds/consultation_paper_en.pdf

default swaps whose speculation seriously aggravated the crisis in Greece and the Euro in 2010.

- Creating, offering, operating and investing in (so-called “exchange traded”) commodity funds that speculate in food, oil and metal prices.
- Investing in land (“land grabbing”) in developing countries.
- Investing in “vulture funds” that buy third world country debt at reduced prices and then sue those countries to get the full repayment of the debt.
- Increasingly investments of money from wealthy individuals and other investors in (advanced) developing country markets, by marketing their funds in those countries.

The operations of **private equity funds** also result in different problems and speculative risks, including:

- Investments in, and buying up, companies with much more borrowed money than their own money by using a lot of loans (“leverage”) to finance their speculative strategies and then offloading the debt to the company which they bought.
- Using all kinds of cost cutting strategies, including lay offs, to repay the debt (resulting in so called “asset stripping”).
- Selling the company again after a short period of time for a high profit.
- Having trouble to pay off their debts once the financial crisis made loans and high profits at companies more difficult.

Private equity increasingly uses its investment strategies in the more advanced developing countries. In India for instance, private equity investments jumped from $2.2 bn in 2005 to $17 bn in 2007, often making huge profits[39]. They invest in all industries, including micro-finance in India.

New regulation

After much heated debate, the EU finally agreed on 11 November 2010[40] to regulate the very speculative investment AIF funds, but only in an indirect way, namely by regulating the managers of AIF (AIFM). The new EU law will be called the Alternative Investment Fund Managers Directive (AIFMD) and be implemented in the member states by 2013.

The main elements[41] of the new EU regulation are:

- registration: AIFM based in the EU with more than 100 million under management (including leverage) have to register and apply the new regulations; not all AIFM will have to fully apply the Directive;
- more transparency: mandatory reporting about AIFM activities to the public, employees in which private equity invests, to investors and to competent authorities;
- minimal capital requirements;
- remuneration principles : binding rules on remuneration of the AIFM and their employees, to avoid the huge bonuses which are an incentive to take high risks;
- regulation of risk management by AIFM and liability;

[39] K. Singh, Fixing global finance, 2010, p. 40-42.
[40] European Parliament, “Parliament ushers in new EU rules for hedge funds and private equity”, Press release, 11 November 2010, http://www.europarl.europa.eu/en/pressroom/content/20101110IPR93908
[41] For more details, see the different issues of SOMO WEED Newsletter –EU financial reforms to be viewed at http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletters

- supervision: will allow (but not oblige) competent authorities to intervene to stop the use of too high and risky levels of loans, as well as restrict abusive practices such as ‘short selling’;
- non-EU AIFM: AIFM who are not based in the EU will only get permission to operate in all EU member states if they are based in a country or jurisdiction that meets minimum regulatory standards and cooperates effectively against tax avoidance and anti-laundering (information sharing agreement);
- after some years, the admission rules for non EU AIFM will become similar in all countries and allow them to operate all over the EU.

Comments from a developing country perspective

The new regulation is not changing the basic strategies and functioning of hedge funds and private equity. Their highly speculative strategies have proved to be risky, harmful and sensitive to crises, namely by searching for high profits and using huge amounts of debt (‘leverage’). The AIFMD has still many shortcomings and loopholes[42] which will limit its impact on reducing the risks of the AIF for the financial sector and for companies in which they invest (taking capital out of the company at the expense of employment). Nor will AIFMD stop hedge funds from investing in commodity derivatives. As is already clear from figures in 2010 (see above[43]), hedge funds are again hugely investing in agricultural commodity markets. As this speculative investment is linked to rising prices for food stuff imported by developing countries, international warnings are being issued about new increasing hunger by the poorest.[44]

The new EU rules on hedge funds and private equity, together with the current low returns on investment in developed countries, might turn even more AIF to developing countries. If not well regulated, AIF can cause many problems and increase risks in the financial sector of their new host countries, and withdraw huge profits out of developing countries, rather than providing more capital and long term investments. The EU should provide sufficient support and (financial) means to improve regulation of AIF(M) in developing countries.

There is a need for all institutions of the EU as well as the member states, academics and civil society to monitor the impact of hedge funds and private equity for their impact not only on societies in the EU but also in developing countries. European supervisors of AIF and AIFM should provide mechanisms so that they consult authorities from developing countries and have channels of communication to receive complaints by employees, civil society and developing country stakeholders about AIF behaviour. When harmful practices are visible, swift action should be taken to review the AIFMD.

[42] See for instance: The Greens – European Free Alliance in the European Parliament, “Fonds speculatifs: une directive insuffisante”, press release, 26 October 2010.
[43] E. Moya, Art. “Field of Dreams: Hedge Funds Put Faith in Grain”, The Guardian, 19 October 2010.
[44] O. De Schutter, Food Commodities Speculation and Food Price Crises - Regulation to reduce the risks of price volatility, United Nations Special Rapporteur on the Right to Food, Briefing Note 02 - September 2010,

4. The link between financial sector reform and EU monetary & economic governance

4.1 Lack of reform in EU financial decision making

The financial sector reforms described in the previous chapter are the result of a process that the European Union started at its conception. Over the decades, the EU has gradually designed ways to allow and implement freedom of capital movement and the free movement of financial services.[45] While cross-border banks and financial conglomerates moved freely in EU countries, EU member states failed to institute a parallel regulation and supervision at the EU level out of fear that they would lose sovereignty and competitive advantage. Worse, the increased competition among EU member states resulted in the financial industry lobbying governments to reduce, or refrain from, national or EU regulation and supervision.

The decision making process[46] at the EU level to regulate the financial sector can only be initiated by the European Commission (EC), who can ignore demands for regulation by the European Parliament and the Council of Ministers. The responsible division of the EC, namely Directorate General Internal market and services (DG Markt), is also responsible for promoting the 'competitiveness' of the financial industry. These two functions clearly constitute a conflict of interest since before the crisis enhancing competiveness was often interpreted as reducing regulation. Once the EC has made a proposal, the European Parliament and the Council of Ministers co-decide on the final version, which can be totally changed from what the EC proposes.

The EU's inconsistencies in governing its financial sector were one of the structural underlying causes of the financial sector crisis in 2008. It became an economic crisis after banks started to drastically reduce credit to the economy/industry. Developing countries were seriously affected by this economic crisis because demand for their exports dropped, foreign direct investment and portfolio investment declined, remittances from migrants decreased and financing flows diminished in 2008 and 2009.

While the crisis started EU reforms of the financial sector, as described in the previous chapters, there is still no discussion on how to reform the EU decision-making process to regulate and supervise the financial sector. The slow decision-making on the reforms since autumn 2008 resulted, for instance, in the lack of restrictions on excessive speculation in derivative markets – which is also harmful for developing countries – even two years after the crisis. The continued huge influence of the financial industry lobby[47] remains a serious structural obstacle for financial sector reform that promotes the interest of society and socially and environmentally sustainable economies.

The crisis in 2008 also revealed that the EU had no mechanisms to decide on how to resolve a crisis or bankruptcy at cross-border banks headquartered in the EU, which also involves the Ministries of

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[45] See M. Vander Stichele, Strategic mapping of EU influence on global financial regulation – Insight into the EU decision making structures on financial regulation and supervision, (Research undertaken for the consortium of Eurodad, WEED, Bretton Woods Project and Campagna per la Reforma della Banca Mondiale), November 2008, <http://www.eurodad.org/uploadedFiles/Whats_New/Reports/EUMapping_Financial_Regulation_FINAL.pdf>.

[46] For full details how the decision making process worked until Autumn 2008, see: M. Vander Stichele, Ibidem.

[47] See for instance: Corporate Europe Observatory, Regulating investment funds: the power of filthy lucre, November 2010, http://www.corporateeurope.org/lobbycracy/content/2010/11/regulating-investment-funds; see also: I Hall, Art. "Conservatives in the European Parliament reveal lobbyist meeting details", Public Affairs News, 8 November 2010 http://www.publicaffairsnews.com/no_cache/home/uk-news/news-detail/newsarticle/conservatives-in-the-european-parliament-reveal-lobbyist-meeting-details/73/

Finance. Instability of banks that were also operating in developing countries, was a result. The EU's decisions on improved supervision as described in Chapter 2 will only partly solve the problems. It took until October 2010 for the EC to present ideas on how to prevent and resolve crises at EU cross-border banks in preparation of the first legislative proposals planned for 2011[48]. The EC's ideas include a "coordination framework with third countries" with no concrete or new proposals which would ensure that developing countries affected by a bank crisis or bankruptcy would have sufficient say to protect their interest.

4.2 Monetary and economic governance and the financial markets

The handling of the economic crisis that followed the financial sector crisis also showed the lack of mechanisms and coordination between EU member states, which can tackle and solve economic crises. Some of the stimulus measures that EU member states enacted, in an uncoordinated way, were protectionist and the EU institutions were not capable of preventing all of them. Some of the protectionist measures harmed developing countries' economic interests, for instance when production was not transferred to a developing country but remained in the country that provided the stimulus measure.

The government money that was used to bail out the large (mostly cross-border) banks and the financial markets, created huge budgetary deficits in member states. This revealed a weakness in how the Euro was introduced and functioning. The Euro had been very much promoted and welcomed by the financial industry as the Euro reduces costs for cross-border activities. However, by failing to strictly institute, support and enforce economic, budgetary and social cooperation and governance, such as in the Stability and Growth Pact[49], the Euro enhanced the differences in countries adopting the Euro. Some Euro countries ran (hidden) higher budgetary deficits than agreed. Some banks failed to incorporate the differences and lent on equal conditions to unequal countries (e.g. Greece vs Germany). Moreover, the limited mandate of the European Central Bank –which is neo-liberal oriented[50] – prevents it from intervening when asset bubbles are created. Financial markets have exploited these differences and the failures of the incomplete financial and monetary architecture. As a result, countries were left at the mercy of the still unregulated financial (derivatives) markets, hedge funds, etc., who speculated against governmental bonds and the Euro, as was clear during the Greek, Irish and Euro crisis in 2010 and beginning 2011. In response, beginning 2011, governments from Euro countries cut their public expenses and discussed a Euro Pact, or pact of competitiveness, which would impose stricter conditions and supervision on Euro countries' budgets, salaries of workers, pension age, etc. in order to harmonize governance of the Euro zone.

The instability of the Euro also harms developing countries that are interested in stable foreign currencies to prevent unfavourable or volatile exchange rates harming their export industry and import prices. It remains to be seen to what extent new Euro governance mechanisms[51] will make the Euro less vulnerable to speculation by the financial markets. This means that the Euro is not yet a safe alternative for over-reliance of the dollar as an international payment currency.

Many EU member states started to cut their budgets for 2011 without any coordination. This might have consequences for some developing countries which have not yet been able to recover and for

48 European Commission, Communication on a new EU framework for crisis management in the financial sector, 20 October 2010, http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm

49 For more explanation, see for instance: http://en.wikipedia.org/wiki/Stability_and_Growth_Pact

50 See for instance: P. Wahl, Fighting Fire with Buckets – A guide to European Regulation of financial markets, October 2010, p. 8-11, http://www.weed-online.org/themen/english/4148887.html

51 The EU heads of state decided during the European Council that member states should limit their budget deficits (not trade deficits) and have mechanisms to monitor & deal with member states who do not respect this rule (without automatic sanctions), limit asset bubbles, etc.

whom exports for European consumers might be an economic stimulus, as was already the case for some emerging market countries.

4.3 The EU's refusal to implement a financial transaction tax (FTT)

Instead of cutting their budgets for public and social spending, EU governments could fill their empty 'coffers' through a financial transaction tax (FTT). Many civil society organisations in the EU argue in favour of an FTT that would impose a minimal tax (e.g. 0.02 %) on financial transactions[52]. This would provide income to governments to deal with the crisis, the budget deficits resulting from the bail-outs, and provide means to finance sustainable development needs in developing countries. The tax could become higher in times of excessive speculation so that it functions as a breaking mechanism ('sand in the wheels') for (institutional) speculators and other actors who profit from (minimal) price differences in financial markets.

Although France, Germany and a few other EU countries are in favour of an FTT, and the EC finally openly recognised that the financial sector is undertaxed, no consensus had been reached yet in October 2010 to introduce an FTT at EU level. The EU and many member states were more in favour of introducing bank levies and a financial activities tax.[53]

EU member states are willing to promote the introduction of an FTT at international level, namely at the G20 level (see below), as a condition to introducing an FTT at EU level. However, many developing countries are against an FTT because they do not want to burden their financial sector which did not cause or contribute to the financial crisis. Others like Thailand are considering introducing an FTT to reduce 'hot money' flowing into the country, amongst others from the US and EU monetary and stimulus policies (e.g. 'quantitative easing'). The German proposal to only introduce the FTT at EU or Euro-zone level might therefore be a good alternative. Several studies have shown this would be technically feasible.[54] Part of the income could be allocated for developing countries.

[52] See for more explanation, for instance: http://europeansforfinancialreform.org/
[53] For more information, see SOMO-WEED Newsletter EU financial reforms, Issue nr 3, October 2010, and Issue nr 4, November 2010.
[54] See for instance: WEED Newsletter EU financial reforms, Issue nr 3, October 2010, http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/october-2010/renderTextHTML?footer_url=http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/october-2010/xxx

5. The EU, its member states and international decision making on financial sector reforms

The financial sector reforms described in chapters 2 and 3 have been part of what has been agreed at the international level, i.e. G20, as is explained in this chapter. The G20 decisions on financial sector reforms, however, do not go beyond what EU members are willing to agree at EU level. What is special for the EU is that only a few EU countries are member of all the international bodies where financial sector reforms are being decided and that the EU as such has no official representation in some of these bodies. The EU speaks with one voice only when negotiating liberalisation of financial services through free trade agreements, an issue which is not on the agenda of the G20. Developing countries who sit in international bodies to decide on financial sector reforms and liberalisation thus deal with different parts of the EU.

5.1. The EU in international fora[55]: financial reforms and new issues

In order to deal with the crisis and financial reforms, the EU member states have been actively manoeuvring to ensure that the international decision-making process was established at the G20, and not the UN. The EU hardly took note of the report[56] by the UN Commission of Experts on the Global Economic and Financial Crisis, chaired by Professor Stiglitz, and ignored the UN follow up process. In contrast, the G20 declared itself to be the only international forum where decisions on financial reforms would take place even though it is an informal body with no legal powers. The EU and four EU member states (France, Germany, Italy and the UK) became very active in the G20 whose meetings were sometimes attended by Spain and the Netherlands. Twelve large developing countries are part of the G20: Argentina, Brazil, China, India, Indonesia, Mexico, Saudi-Arabia, Turkey, South-Africa and South-Korea. As a result, the main international decisions on the financial architecture, financial sector reform and solutions to the crisis are taken in an informal body, the G20, where many EU member states and most of the developing countries do not participate. Civil society worldwide considers the G20 undemocratic and illegitimate.[57]

Similarly, not all EU member states and developing countries are represented in other international bodies setting standard for the financial sector, such as the Basel Committee on Banking Supervision[58] (which agrees on standards and guidelines for regulating and supervising banks) and the Financial Stability Board[59] (which coordinates and advises the G20 on international regulatory and supervisory policies). At the IMF, which has a monitoring and executive function in the financial system, only individual EU countries are members and not the EU as such. EU member states have

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55 See also for more explanation: M. Vander Stichele, Financial regulation in the European Union - Mapping EU decision making structures on financial regulation and supervision, December 2008, <http://www.eurodad.org/uploadedFiles/Whats_New/Reports/EUMapping_Financial_Regulation_FINAL.pdf>

56 An initiative of the General Assembly of the UN : the report "Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System" was presented in September 2009, http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf

57 Joint Declaration Concerning the G20 Summit in Seoul, Civil society declaration, 10 November 2010, http://en.putpeoplefirst.kr/?mid=g20_board_en&document_srl=103345&sort_index=regdate&order_type=desc

58 www.bis.org/bcbs

59 www.financialstabilityboard.org

been extremely reluctant to give large developing countries more voting rights at the expense of small EU member states.

The G20 Summits have been making agreements on financial sector reforms such as regulation; supervision and crisis resolution of banks and systemically important financial institutions; OTC derivative trading; credit rating agencies; and tax havens and hedge funds.[60] The EU has been implementing most of them, be it somewhat late, as explained above.

However, the latest G20 meetings have topics on their agenda which have become of utmost importance for developing countries but about which the EU member states have not agreed upon at EU level, and are even divided about at an international level. These issues which were hotly debated at the Seoul G20 meeting on 11-12 November 2010 are:

- introduction of a Financial Transaction Tax (see above);
- the global imbalances between countries with trade surpluses and deficits and budgetary surpluses and deficits;
- the use of money printing vs. budget cuts by G20 governments to solve economic crisis issues;
- dealing with highly fluctuating foreign exchange rates (and reacting to different proposals for an international currency[61], international cooperation for a new monetary system, etc.);
- the use of controls and restrictions on capital flows in order to keep the value of their currency low to be able to export: the so-called currency wars.

On the issue of capital controls, which some G20 developing countries are increasingly using[62], it will be difficult for the EU to agree on their use by others and by the EU itself.
The Lisbon Treaty (Art. 63-66) only allows temporary interventions to restrict cross-border capital movements with third countries in exceptional circumstances after difficult procedures. This is one of the pillars of the free market principles that dominates the EU's economic policy. However, the use of capital controls has been increasingly acknowledged, even by the IMF[63], as a useful tool to protect a country against attacks from international and institutional speculators such as hedge funds, OTC derivative traders, etc., which have not yet been regulated. The implementation of regulation of speculation agreed in the US and EU will not take place until 2013 for example regarding hedge fund regulation.

The capital control issue is also at stake in the EU's position in free trade and investment negotiations where the EU speaks with one voice (see below).

Conclusions, missing issues and recommendations

The European financial industry has been operating worldwide but the international decision-making on standards, regulation, supervision and crisis management is taking place in informal bodies with no legal powers such as the G20 and the Financial Stability Board. These bodies only represent a small group of countries, albeit with a large part of the world population. The participation of the EU and the EU member states is diverse in these bodies and allows EU member states to voice different positions at international level.

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[60] For the G20 declarations about these issues and follow up reports, see: www.g20.org

[61] See for instance: "Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System", September 2009; A. Beattie, Art. "Zoellick seeks gold standard debate", The Financial Times, 7 November 2010.

[62] K. Singh, Art. "Will G20 take collective stand on capital controls?", The Korea Times, 10 November, 2010: Brazil, Indonesia, South Korea

[63] Ibidem.

What is absent in the current international fora that decide on reforms of the financial sector and monetary system ('the international financial architecture') is that none of the proposals or decisions are directly providing means and mechanisms to finance the transformation of the economies and societies towards more socially and environmentally sustainable development.

In order to strengthen international decision-making on financial sector reform and the international financial architecture, the EU should:

- Have a strong commitment to cooperate at international level to drastically reform the financial sector.
- Reform its decision-making at EU level regarding its representation at international fora where financial, monetary and economic reform and cooperation is decided.
- Actively promote that all developing countries' interests regarding financial reforms are heard and taken into account, preferably at UN level, with improvements in UN functioning and involvement of UNCTAD's expertise. Also, international bodies where Central Banks decide should allow the participation of more developing country representatives.
- Actively promote and engage in discussions on ways to achieve a stable international currency system, and assess what should be the role of the Euro and the Euro's governance. One of the solutions to be explored is regional funds on all continents to deal with monetary problems or a regional currency.
- Reconsider the EU's principle of free movement of capital and support international mechanisms that allow the orderly use of capital controls against speculation at international level in case no FTT is agreed upon.

5.2. Agreements on free trade in financial services undermine financial reforms

The aforementioned international fora that decide on financial sector reforms have so far failed to discuss what the impact has been of free trade agreements that liberalise financial services. However, the previously mentioned 'Stiglitz Committee'[64] has warned that financial reforms or anti-crisis measures were being undermined by such trade and investment agreements, i.e. in the General Agreement on Trade in Services (GATS) that is part of the World Trade Organisation (WTO), in bilateral and regional free trade agreements (FTAs, some of which are called Economic Partnership Agreements (EPAs)), and in bilateral investment treaties (BITs).

GATS and FTAs liberalise trade and foreign investment in many of those financial products and financial services providers, which are currently being reformed, ranging from basic banking services to OTC derivative trading and asset management (e.g. hedge fund managers).[65] The EU currently negotiates financial services in GATS as part of the WTO's Doha Round and with many developing countries as part of FTA or EPA negotiations. During those negotiations, the EU prioritises ever-increasing market access for the European financial industry whose cross-border financial services trade and investment in countries outside the EU is considered to be very profitable. The EU has been, and is, pushing for liberalisation of financial services even if no sufficient international, EU or national regulation and supervision is in place (as is described above).

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[64] The UN Commission of Experts on the Global Economic and Financial Crisis, chaired by Professor Stiglitz stated that: *"The framework for financial market liberalisation under the Financial Services Agreement of the General Agreement on Trade in Services (GATS) under the WTO and, even more, similar provisions in bilateral trade agreements may restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors"'*

[65] GATS, Annex on Financial services (1995), Art. 5 : definitions

The GATS and FTA texts that are currently negotiated, or that have recently[66] been agreed upon, are based on the pre-crisis model of “light touch” regulation, i.e. as little regulation as possible and preventing governments to re-regulate. For instance, during the GATS negotiations in 2002, the EU asked developing countries to eliminate regulations that were put in place to prevent a financial crisis[67]. So far, the EU has not changed its negotiation stance in GATS or FTAs. The EU supports the view of the WTO Secretariat[68] who refuses to recognise that GATS liberalisation in financial services provided legal certainty for speculative financial services providers and risky financial products to move around the world, which reinforced the financial crisis and its underlying mechanisms.

The current financial reforms are faced with the problem that the GATS and FTA agreements impose serious disciplines on governments regarding how to regulate and treat foreign and domestic financial service providers and their financial products. These disciplines have to be adhered to by those signatory countries that explicitly liberalise financial services under the agreement, which is inscribed in the list of “commitments” attached to the agreement. Under GATS and FTAs, many developing countries have made commitments in financial services.

Various GATS/FTA rules describe the disciplines by which governments are restricted from regulating and reforming the foreign as well as domestic financial industry. Some examples are[69]:

- Countries that made commitments to allow financial services (providers) of WTO countries into their markets, can only reverse those commitments if they pay compensation as requested[70]. This makes it difficult for these countries to, for instance, forbid existing OTC derivative trading or halt food commodity derivative trade in order to avoid excessively high food prices due to speculation.
- Countries cannot impose restrictions on the size and value of the operations of financial service providers. This rule contradicts measures taken for instance to prevent excessive speculation or banks becoming too big to fail. If a WTO member country contests such measures taken by another WTO member, the GATS rule that allows prudential regulation for the stability of the financial system might not apply. The only possibility to fully escape those GATS and FTA rules is when countries have included ´exceptions´ in their commitments at the time of negotiations.

GATS and FTAs also forbid, or strictly discipline, capital or currency controls. Developing countries have increasingly used all kinds of capital controls[71] to protect their economies, companies and societies from attacks by foreign speculators and to prevent a financial crisis resulting from money printing by the US. In fact, trade and investment agreements incorporate the EU’s own rules that guarantee the freedom of capital movement: only temporary interventions to restrict cross-border capital movements with third countries can be taken in exceptional circumstances based on difficult procedures and criteria (The Lisbon Treaty (Art. 63-66)). Developing countries who sign FTAs with the EU lose the possibility to use capital controls to prevent a crisis.

Moreover, the Lisbon Treaty has provided the EU with new competences to deal with investment agreements. The EU is currently discussing how such new investment agreements would impose signatory countries to provide high levels of protection to foreign investors, including those investing in

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66 See for instance, the EU – Cariforum EPA, the EU – South Korea FTA.
67 See M. Vander Stichele, 2005.
68 WTO Secretariat, Financial Services: Background Note by the Secretariat, 3 February 2010.
69 For full (technical) explanation, see: M. Vander Stichele, R. van Os, Business as usual? How free trade in financial services works against public interests and jeopardizes financial sector reform
70 Compensation is paid to those countries who ask for compensation based on the estimate for the loss of profits to their financial industry.
71 See for instance K. Singh, Art. “Will G20 take collective stand on capital controls?”, The Korea Times, 10 November 2010.

the financial services sector. This might prevent host governments for instance from re-nationalising banks or re-regulating financial markets.[72]

Main concerns and recommendations

GATS/FTA rules are restricting developing countries from taking measures that can protect them from financial crises, such as capital controls, which they are increasingly using in 2010. The contradictions between GATS/FTA rules and financial reforms or anti-crisis measures reduce the policy space governments should have to re-regulate the financial sector.

In order to make the EU policy of liberalising financial services through free trade and investment agreements coherent with the EU financial reforms, the EU should:

- Put the GATS/FTA liberalisation of financial services on the agenda of international fora where financial reforms are decided. It should then be discussed how liberalisation of financial services should be part of the international financial reform mechanisms and not be left to trade and investment treaty negotiations.
- The EU should fully and openly assess the impact of the free trade rules on the financial crisis and financial (re-)regulation, and assess whether to continue to incorporate financial services in free trade agreements. The assessment should be the start of a discussion and decision about other options for governing free trade in financial services.
- The EU should not continue to negotiate liberalisation of financial services in GATS/FTAs before an assessment is made.
- EU should not continue to negotiate liberalisation of financial services in GATS/FTAs before all necessary international and EU regulation and supervision are in place.
- The EU should allow developing countries to impose capital controls and all other measures needed to prevent a financial crisis and regulate the financial sector. In general, the EU should allow developing countries to withdraw their GATS/FTA commitments in financial services without asking for compensation.

[72] See for instance: Seattle to Brussels, EU investment agreements in the Lisbon Treaty era: A Reader, October 2010, http://www.s2bnetwork.org/fileadmin/dateien/downloads/eu_investment_reader.pdf

6. Concluding remarks

As this report does not provide a full overview[73] of all the decisions and initiatives on financial sector reform taken by the EU, it is important to note that some reforms are missing to protect the international financial system from new or continued instability and mistakes based on wrong free market and neo-liberal assumptions.

First, the official EU agenda contains no proposal to separate or split basic retail banking from risky investment banking. On the contrary, many investment banks were rescued and merged in a way that now deeply embeds them into internationally operating banks that have more than ever become "too big to fail". The EU competition authorities have only requested some bailed out banks to shrink or stop expanding. Consequently, banks with risky behaviour and speculative strategies continue to operate in developing countries.

Second, there is no guarantee to the public that banks will not go bankrupt. Proposals made by the European Commission in October 2010[74] to deal with cross border banks in crisis include mechanisms to let banks fail in an orderly manner. No proposals are made to create public banks that guarantee basic banking services or to promote alternative banking institutions, such as ethical banks, green banks, cooperative banks, mutual societies, etc. A new diversity of banks is also important in developing countries given the interesting banking initiatives that have already emerged.

Third, the issue of tackling the financial industry's use of tax havens seems to have been downgraded. However, offshore banking and channelling money through tax havens by the financial sector and other businesses results in huge losses for coffers of both industrialised and poor countries.

What is missing overall is a lack of vision that links the financial crisis with other crises in society such as the climate crisis, the food and poverty crisis, and even the crisis of democracy in the EU (caused by undue financial industry lobbying). The EC did not start the financial sector reforms by formulating what the purpose and the function of the financial sector should be, in the EU and elsewhere in the world. Indeed, the EU financial reforms lack a vision of how the financial industry should be at the service of a sustainable society, worldwide, and what model would be least crises-sensitive. However, the neo-liberal models, some of which are incorporated in the Lisbon Treaty (e.g. free movement of financial services and free movement of capital), might have prevented the EU member states to take new bold steps. As it now stands, EU financial reforms do not go beyond preventing the worse instability and riskiness of the financial sector.

The slowness and the weakness of the financial reforms currently on the EU table reflect how national governments, regulators, and supervisors continue to consider it their task to protect the attractiveness and competitiveness of the financial industries in their respective countries, which are seen as important sources of income and jobs. The competitiveness argument and the complexity of the issues have been used by the financial industry to gain enormous political power and use its huge financial resources to lobby against any reform that would curtail its huge profits. Continued political protection of financial sector interests is now conflicting with the governments' task to protect the public interest against financial instability, speculation and financialisation of the economy. All the latter being ways by which the financial sector increases the gap between the rich and the poor. The interests of developing countries are hardly considered in this EU approach.

[73] For a better overview see: http://ec.europa.eu/internal_market/index_en.htm; see also: SOMO-WEED Newsletter EU Financial Reform, http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletters

[74] See http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm

Against this continued focus on competitiveness and so-called regulatory and supervisory arbitrage, more political discussions and reforms need to explore alternatives and thinking out of the box of neo-liberal thinking. For instance, more research should define what could be the size or financial sector models that would be economically and socially useful and fulfil the public interest in a sustainable way. More thinking out of the box could be supported by a report by France's Commission on the Measurement of Economic Performance and Social Progress, led by Professor Stiglitz: it could be of use to design a financial system that serves especially the poor, helps reverse climate change, promotes food security and sustainable energy. What needs to be eradicated is the current functioning of the financial sector of maximising profits and making money from money at the expense of society and the climate rather than financing a sustainable economy and society, in the EU and elsewhere in the world. The EU is far from this approach but continued crises, more public debates and protests might force it to change direction.

ANNEX: Glossary[75]

Alternative Investment Funds (AIF) are defined by the European Commission as all funds that are at present not harmonised under the UCITS Directive

Asset stripping is the practice of buying a company in order to sell its assets individually at a profit;

Bank branch is an office of a bank based in another country than the head office. A branch is fully subject to supervisors in the country of the head office.

Bank subsidiary is an office of a bank based in another country than the head office. Subsidiaries are subject to supervision by supervisors from the country of the head office (home supervisors) and those of the host country (host supervisors). Cooperation and decision-making between the two supervisors is somewhat agreed by the Basel Committee on Banking Supervision but is part of the discussions about reform of the supervisory structures.

Capital requirements: Regulations on capital requirements set criteria for minimum capital reserves for banks, so that every loan granted is being covered by a certain percentage of the bank's own money. This way the bank can cover defaults on loans and not go bankrupt when too many borrowers default. The Basel Committee on Banking Supervision (BCBS) started to work on a new Basel Capital Accord in 1999. After five years of consultations, the Basel Capital Accord II (Basel II) was finalized by the BCBS in June 2004. Basel II not only sets the amount of capital reserves, but also regulates how banks should calculate the risks of the loan for which capital reserves are needed, and describes how supervisors should deal with the Basel II regime.

Carbon derivatives: see derivatives.

Clearing is the process by which obligations arising from a financial security are managed over the lifetime of a financial contract. It is also the way by which risks are outlined and mitigated. Until now, credit default swap (CDS) trades – like most over-the-counter (OTC) financial derivatives – are predominantly cleared bilaterally between two contracting parties.

Collateralized Debt Obligations (CDO) consists of a pool of assets and/or mortgage backed securities with loans, bonds or other financial assets as the underlying. A CDO is divided into different risk classes (tranches), whereby "senior" tranches are considered the safest securities. Interest and principal payments are made in order of seniority, so that junior tranches offer higher payments (and interest rates) or lower prices to compensate for additional default risk. This implies that junior tranches will be first in line to absorb potential losses in case of default. Each tranche has its own credit rating based on the potential risks.

Commodity derivatives have commodities, such as oil and agricultural products, as the underlying value of a contract; a derivative. The prices of commodities have become a target of speculation and are now instruments for investors to diversify portfolios and reduce risk exposures.

Credit default swaps see derivatives.

Credit risk is the risk that the debtor of a loan or other type of credit will not (be able to) repay it's debt.

[75] http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/glossary

Credit securitization consists in repackaging loans in tradable securities.

Derivatives are financial instruments whose prices are based on the price of an underlying instrument, such as assets, credits, foreign exchanges, interest rates or commodities. A derivative contract specifies the right or obligation between two parties to receive or deliver future cash flows, securities or assets, based on a future event. The underlying itself is not traded. However, small movements in the underlying value can cause a large difference in the value of the derivatives as a derivative is often leveraged. For example, the financial crisis has shown us the consequence of a decrease in American housing prices, which was an underlying for many derivatives. Derivatives traders speculate on the movement of the value of the underlying, this way attempting to make profit. Furthermore, derivatives are often used to hedge (insure) against the risk) of an investment in the underlying instrument.
Derivatives can be broadly categorized by:

- The relationship between the underlying and the derivative
- **Futures** are contracts to buy or sell a specific amount of commodity, a currency, bond or stock at a particular price on a stipulated future date. A future contract obligates the buyer to purchase or the seller to sell, unless the contract is sold to another before settlement date, which happens if a trader speculates to make a profit or wants to avoid a loss.
- **Options** are the right, but not the obligation, to buy (call option) or sell (put option) a specific amount of given stock, commodity, currency, index or debt at a specific price during a specific period of time. Each option has a buyer (called a holder) and a seller (known as the writer). The buyer of such a right has to pay a premium to the issuer of the derivative (i.e. the bank) and hopes the prices of the underlying commodity or financial asset to change so that he can recover the premium cost. The buyer may choose whether or not to exercise the option by the set date.
- **Swaps** involve two parties exchanging specific amounts of cash flows against another stream. The swap agreement defines the dates when the cash flows are to be paid and the way they are calculated.
- The type of underlying
- **Equity** derivatives are derivatives with the underlying existing of equity securities.
- **Foreign exchange/currency derivatives** with the underlying existing of a particular currency and/or its exchange rate.
- **Credit derivatives** are contracts to transfer the credit risk of an entity from one counterparty to another. The underlying exists of a bond, loan or another financial asset.
- **Credit Default Swaps (CDS)** are insurance contracts by which investors protect themselves in case of future defaults. For this "insurance" the protection buyer pays a premium to the seller of the CDS and the seller is obliged to make a payment in the event of a default by the "insured". The contracts are thus used to transfer credit risks. These type of contracts are usually not closed on the regulated and supervised exchanges but rather over-the-counter. Besides this, there exist so-called "naked" credit default swaps, whereby the protection buyer does not hold (or does not have any interest in) the underlying bond. This way naked CDS's give purchasers the ability to speculate on the creditworthiness of a company without holding an underlying bond. The overall CDS market has grown many times the size of the market for the underlying credit instruments and causes systemic risks.
- **Commodity derivatives** have commodities, such as oil and agricultural products, as the underlying. The prices of commodities have become a target of speculation and are now instruments for investors to diversify portfolios and reduce risk exposures.

- **Carbon derivatives** have pollution permits as the underlying. The emission trading is based on the principle that polluting companies buy carbon credits from those who are polluting less somewhere in the world and have therefore pollution permits to sell. Financial engineers already developed complex financial products, such as derivatives, to speculate and such products are now seen as a potential financial bubble.
- The market in which derivatives are traded
- **Exchange traded derivatives** are products that are traded via specialized derivatives exchanges or other exchanges. A derivatives exchange acts as an intermediary to all related transactions, and demands a deposit from both sides of the trade to act as a guarantee to potential credit risks..
- **Over The Counter (OTC)** trading is an exchange directly between the buyer and seller. Around 85% of the derivatives transactions are over-the-counter. They are not listed on the exchange and there is no trade through third parties, this way making the market much less transparent.

Equity is the value of assets after all liabilities have been paid.

Hedge Funds are specialist investment funds that engage in trading and hedging strategies. Hedge funds make use of speculative strategies, such as short-selling, leverage and derivative trading to obtain the highest possible return on their investments. These funds aim to make short-term profits by speculating on the movement of the market value of the shares, the sustainability on the long-term is inferior. Moreover, hedge funds are activist shareholders, which use a certain amount of shares to influence the outcome of the general meeting of shareholders and so the long-term strategy of a company with the aim to make short-term profits.

Leverage is the use of borrowed funds at a fixed rate of interest in an effort to boost the rate of return from an investment. Leverage takes the form of a loan or other borrowings (debt), the proceeds of which are (re)invested with the intent to earn a greater rate of return than the cost of interest. Increased leverage also causes the risk on an investment to increase. Leverage is among others used by hedge and private equity funds. This means that they finance their operations more by debt than by money they actually own. The leverage effect is the difference between return on equity and return on capital employed (invested).

Moral hazard refers to the principle that in good times the profits of the financial service industry are privatized, while the losses in case of emergency are socialized. Financial bail-outs of lending institutions by governments, central banks or other institutions can encourage risky lending in the future, if those that take the risks come to believe that they will not have to carry the full burden of losses. Lending institutions need to take risks by making loans, and usually the most risky loans have the potential for making the highest return. So called "too big to fail" lending institutions can make risky loans that will pay handsomely if the investment turns out well but will be bailed out by the taxpayer if the investment turns out badly. It can concluded that moral hazard has contributed significantly to the practices of excessive risk-taking by the financial sector.

Naked short-selling: see short-selling.

Off-balance sheet practices refer to certain assets and debts that are not mentioned on the balance sheet of the company. These practices are not transparent and lack of oversight by supervisors. Banks have traditionally used off-balance-sheet practices to avoid reporting requirements or to reduce the amount of capital they needed to hold to satisfy regulatory requirements.

Over-the-counter (OTC): see derivatives.

Private equity funds vary from hedge funds as they operate in a different way as an activist shareholder. Generally speaking, private equity funds engage in two types of activities: a) they provide venture capital for start-up firms and small business with growth potential that look for investors; b) their most substantial and striking activities are leveraged buyouts. Private equity firms have a short term focus as they wants their investment back as soon as possible with the highest return as possible. In the first half of 2006 private equity leveraged buy-outs have got 86% of their investment back in just 24 months engagement in the target company. The biggest five private equity deals involved more money than the annual budgets of Russia and India.

Re-securitizations have underlying securitization positions, typically in order to repackage medium-risk securitization exposures into new securities. Because of their complexity and sensitivity to correlated losses, re-securitizations are even riskier than straight securitizations. See also: securitization.

Securitization is the process of converting a pool of illiquid assets, such as loans, credit card receivables (Asset Backed Securities) and real estate securities (Mortgage Backed Securities) into tradable debt securities. These new sophisticated instruments were supposed to refinance pool of assets, to diminish risks and to enhance the efficiency of the markets, but they resulted in increasing the risks by spreading "toxic assets" throughout the financial system.

Short selling is the practice of selling assets, usually securities, which have been borrowed from a third party (usually a broker) with the intention of buying identical assets back at a later date to return to the lender. The short seller hopes to profit from a decline in the price of the assets between the sale and the repurchase, as he will pay less to buy the assets than he received on selling them. So, short sellers make money if the stock goes down in price. If many market participants go short at the same time on a certain stock, they call down an expected drop in prices because of the growing amount of stocks that have become available. Such practices hold the risk of market manipulation.