The Missing Dimension

How European Financial Reforms Ignore Developing Countries and Sustainability

Myriam Vander Stichele

October 2011
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Author: Myriam Vander Stichele
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Sarphatistraat 30
1018 GL Amsterdam
The Netherlands
Tel: + 31 (20) 6391291
Fax: + 31 (20) 6391321
E-mail: info@somo.nl
Website: www.somo.nl

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About SOMO
SOMO is an independent research organisation. In 1973, SOMO was founded to provide civil society organisations with knowledge on the structure and organisation of multinationals by conducting independent research. SOMO has built up considerable expertise in among others the following areas: corporate accountability, financial and trade regulation and the position of developing countries regarding the financial industry and trade agreements. Furthermore, SOMO has built up knowledge of many different business fields by conducting sector studies.
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1. Introduction and summary

The financial crisis that erupted in Europe in autumn 2008 resulted in an economic crisis that also severely affected many developing countries as documented in many reports.\(^1\) The lack of export opportunities and bank credit for trade, for instance, badly hit the income of developing countries.

In order to prevent a new crisis, the European Union (EU) started to reform its financial sector. Although the financial sector is clearly global and interconnected, whereby many European banks are present in developing countries, little attention is given to what impact the EU’s financial reforms have on developing countries. In addition, the EU financial reforms do not take the global environmental and social challenges into account and make no attempt to ensure that the financial sector supports the transformation to sustainable economies and societies.

This report has selected a series of new financial laws on which the EU has decided or will decide on, made on the basis of the perceived importance for developing countries and sustainable development. It assesses those EU financial reforms and makes recommendations on how they should be improved to integrate the interests of developing countries as well as sustainability. The report ‘Fixing Global Finance’\(^2\) by Indian expert Kavaljit Singh was used as a background document and is recommended reading to understand the issues discussed in this report. The impact of the selected EU financial reforms were first discussed during a SOMO expert meeting (26 May 2010). The resulting draft discussion paper has been circulated since November 2010 and was updated for this report.

This report is part of a project\(^3\) that aims 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. Partner organisations in the project are: AITEC (Fr), Glopolis (Czech Republic), New Economic Foundation (UK), SOMO (NL), Vedegylet (Hungary) and WEED (Germ). Colleagues from these organisations have provided comments on the draft discussion paper and will participate in activities as follow up of this report.

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Summary of the main findings and recommendations of the report

- Although many European banks operate in developing countries, supervisors of these developing countries have no guarantee that they can participate in the new EU bank supervisory structures and defend the interests of their countries.
- The new EU bank reforms insufficiently reduce risky behaviour by banks. The new rules on capital reserves, on which the EU still has to decide, might reduce credit and services by European banks operating in developing countries. The new legislation should force European banks to change the bank business models towards servicing the economy and sustainable societies.
- New EU mechanisms to protect basic financial services and savers’ money in case of bankruptcy should also cover clients of European banks operating in developing countries.
- Credit Rating Agencies (CRAs) can greatly affect how much developing countries have to pay for loans and what investments flow to their country. The reforms that the EU has agreed upon so far do not make CRA ratings sufficiently reliable. The European Commission (EC) needs to act swiftly on its proposed structural reforms. In addition, the EU should impose that ratings fully integrate social and environmental sustainability aspects. Developing countries and their firms need more guaranteed access to high quality ratings, if need be through government sponsored initiatives.
- Because derivatives markets in commodities and foreign exchange influence the prices at which developing countries import and export food, for example, the EC should apply the precautionary principle when regulating these markets. In order to prevent and stop excessive speculation, the upcoming new legislation (MiFID) needs at least to impose strict ex-ante legal limits on how many food commodity derivatives can be held by financial actors. Assessing the social uselessness of the whole derivatives markets should result in a structural overhaul.
- Hedge funds and private equity funds have diverse impacts on developing countries, e.g. by buying up land or companies in these countries for short term high profits. The new EU legislation (AIFMD) will not stop all the harmful activities of these funds. Full assessments of hedge funds and private equity activities in developing countries should guide the review of AIFMD.
- In order to reduce excessive speculation on financial markets, a financial transaction tax (FTT) is a useful tool. The EC, Germany and France have recognised that the FTT might be a means to finance the EU and member states’ budgets to offset the costs of bank bail outs. However, civil society has been arguing for years that income from the FTT should be for developing countries and sustainable development. The new EC proposals for an FTT in the EU are useful but will face many challenges before implementation.
The EU decision-making about financial reforms and economic governance needs to be overhauled because it now includes conflicts of interests, is overly influenced by the lobby of the financial industry at the expense of the voice of civil society and developing countries, becomes ever more undemocratic and imposes social austerity based on a defunct neo-liberal model.

At an international level, the EU should reverse its position that favours the G20 and other small international fora for financial decision making, over the UN where all developing countries, and EU countries, would be able to participate.

The EU’s trade and investment agreements with developing countries, which liberalise financial services are in contradiction with the EU’s financial reforms. Therefore any EU negotiations to liberalise trade and investment with developing countries should be halted and any rules that hamper policy space for financial reforms or capital controls should be reversed.

Overall, the EU financial reforms lack any vision of a financial sector that is at the service of the economy and transformation towards sustainable societies. For instance, the EU does not even propose structural changes in how to separate speculative financial market activities from basic banking services and create a more diverse financial system. More pressure from citizens will be needed to ensure that the financial sector no longer increases the gap between rich and poor but helps to help reverse climate change, promote food security and sustainable production and consumption not in the least in developing countries.

For the reader who is not familiar with all the issues and technical terms in this report, a glossary in the Annex explains many of the technical terms used in this report. The Newsletter on EU financial reforms published by SOMO and WEED, and other SOMO and WEED reports might also be of interest.  

4 All “Newsletters – EU financial reforms” are published by SOMO and WEED and can be downloaded at: http://somo.nl/dossiers-en/sectors/financial/financial; http://www.weed-online.org/publikationen/publikationen/5108791.html
2. Bank reform: no say for the affected developing countries

In several developing countries, foreign banks have a market share of more than 50% – making these countries very vulnerable to the stability of those foreign banks. Some large cross-border banks and financial conglomerates with headquarters in the EU are present in many developing countries.

For example, HSBC (UK) had a presence in 53 developing countries and Credit Agricole (Fr) in 35 developing countries as of October 2011. European banks own a large part of the banking sector in particular developing countries, e.g. Spanish banks in Latin American. Many EU international financial conglomerates or holdings are not only active in banking in developing countries, but also operate insurance, fund management, investment bank and even hedge fund activities.

Before the financial crisis, it was argued that foreign banks increase the efficiency of the banking system in developing countries. Policy makers promoted the presence of foreign banks in these countries and allowed foreign acquisitions of domestic banks. Some countries committed themselves in trade agreements to opening their markets to foreign banks permanently (see chapter 5.3) without guarantee of good supervision and regulation of the home bank. However, just before the crisis, there was also a growing recognition of various negative impacts of foreign banks. For instance, in particular countries foreign banks give less credit than domestic banks do, provide no or little financial services to small farmers, the poor, or small companies, and focus their services on profitable rich clients.⁵

Banks have been playing an important role in the financial crisis that affected the whole world since 2008, especially the large internationally operating financial conglomerates and investment banks, some of which are European. The financial crisis that erupted after Lehman Brothers fell in the US in September 2008, became an economic crisis once banks drastically reduced lending to the economy and companies. Developing countries were seriously affected by this economic and financial crisis in 2008 and 2009 because demand for their exports dropped, financial flows and foreign direct investment declined and remittances from migrants decreased. The crisis revealed the following dangers and vulnerabilities of foreign banks operating in developing countries during a crisis:

Failing supervision and regulation in the home country and at the international level resulted in instability at foreign bank operations in developing countries.

Credit by foreign banks for trade activities (export-import) and (small) enterprises in the host country was reduced, lacking or became very expensive.

International banks withdrew capital from subsidiaries or branches in developing countries in order to meet their urgent need for more capital.

Foreign banks sold subsidiaries or branches in developing countries.

Rescue packages to bail out European banks did not guarantee that capital would also be transferred equally to parts of the bank outside the home country, including to developing countries. The bailout packages are said to have had hidden conditions that more credit was to be provided 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 that 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 and supervision.

### 2.1 Supervision of the European banking sector: reforms ignore developing countries’ supervisors

The financial crisis revealed that supervision of EU cross-border banks and financial conglomerates was insufficient in order to prevent a crisis that had world wide effects. The EU had liberalised its financial services sector without sufficient regulations and supervisory structures, which had remained national. For instance, there were too few mechanisms to make home and host supervisors share information and cooperate when managing a failing EU based cross-border bank or financial conglomerate.

The EU agreed in 2009 and 2010 to improve supervisory structures and created a new European System of Financial Supervisors covering:

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

The ways in which this new supervisory structure affects developing countries and allows their supervisors to participate are discussed below. Some supervisory methods will also be improved under the Capital Requirements Directive 4 as explained under the sub-chapter on new bank regulation.
2.1.1 Colleges of bank supervisors: no guaranteed access by supervisors from developing countries

Colleges of bank supervisors are bodies through which supervisors from the home and the host countries of the same cross-border bank, with headquarters in the EU, meet and consult each other. Colleges of supervisors were strengthened and their functioning improved by the first review of the EU’s Capital Requirement Directive (CRD) in September 2009.\(^6\) The review imposed better cooperation within each supervisory college to prevent and supervise the risks of cross-border banks.

According to the rules\(^7\) and guidelines\(^8\) to improve the functioning of the colleges of supervisors, host supervisors of countries that are not part of the 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 risks by the subsidiary in a developing country for the cross-border bank as a whole. These criteria do not include the significance of that EU based bank for that developing country, e.g. for the payment and savings systems. This contrasts with the criteria used for admitting EEA host supervisors and the advice given by the Basel Committee of Banking Supervision on joint supervision.\(^10\)

Even if a host supervisor from a developing country is admitted to a college of supervisors, the host supervisors might not always be invited to all meetings according to the guidelines.\(^11\) A developing country supervisor can receive all relevant information, but receives no financial or human resource support to travel and contribute to meetings or correspondence. This means that supervisors of developing countries that host a European bank have no guaranteed participation in the cross-border bank supervisory decisions which might affect their country, e.g. when a crisis situation occurs.

In July 2011, the supervision structures of EU based financial ‘conglomerates’ and mixed financial holding companies, which operate bank and non-bank activities also in

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\(^7\) See especially CRD 2, Art. 42a, 129 and 131.


\(^9\) The EEA consists of 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), http://www.bis.org/publ/bcbs177.pdf; “determining appropriate sub-structures the materiality of the banking group in the host jurisdiction(s) should also be considered”; see also Annex 1 on the need of information sharing.

\(^11\) See CEBS guidelines: allow that not all college supervisors participate in some college meetings that deal with particular issues.
developing countries, were reviewed.\textsuperscript{12} By early 2013, the Financial Conglomerate Directive will be imposing extra and common supervisory measures concerning coordination among different kinds of supervisors at national and European levels and publicly available information on the conglomerates' structures. A report to assess whether non-regulated bank activities, e.g. holdings with industrial and banking activities, should also be regulated and supervised, will only be finalised by the end of 2012.

\subsection*{2.1.2. EBA and 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 the host country. Who takes the final decision in case of disagreement is a very sensitive issue because the decision might be beneficial for the home country at the expense of the host countries, and vice versa. In September 2010, the EU introduced new legislation on supervision according to 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. 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.

However, this procedure is based on disputes among EU supervisors. Given that no third country supervisor is part of EBA, and that developing country supervisors might not be part of the college of supervisors (see above), there is no guarantee that disagreements among supervisors will be resolved in a way that protects the interests of developing countries in which a European bank is operating.

EBA is allowed to develop contacts and enter into administrative arrangements with supervisors and administrations from non EU countries and international organisations. However, given the limited financial resources provided to all the supervisory bodies\textsuperscript{13} it remains to be seen how many contacts and arrangements will be made with developing countries supervisors.


2.1.3. A European Systemic Risk Board (ESRB) with no links to developing countries

A newly created European Systemic Risk Board (ESRB)\(^{14}\) needs to assess systemic risks building up in the financial system. The ESRB is composed of all the European supervisory bodies and national central bankers, but can only issue warnings and has no power to act in case of a system risk but. The definition of systemic risks is being interpreted as posing problems to the financial stability and economy in the EU and not of the world as a whole or developing countries particularly. By giving a seat to a central banker from a developing country, the ESRB could widen its perspective.

The ESRB has an Advisory Scientific Committee, whose chair participates in the high level meetings of the ESRB. This Advisory Scientific Committee provides an opportunity to include one or more supervisors or experts from a developing country.

2.1.4. Recommendations to improve the new EU supervisory structures

The newly agreed EU rules on colleges of supervisors of EU based cross-border banks do not sufficiently improve the deficient arrangements between home and host supervisors in developing countries, which already existed before the crisis.\(^{15}\) The following recommendations could improve the functioning of the new EU banking supervision:

- 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 the necessary information sharing arrangements, an invitation to participate in meetings and provision of financial resources.
- When taking binding decisions to resolve disputes among the supervisors of a college, **EBA** should ensure that the interests of developing countries where an EU based bank plays a (significant) role, are taken into account.
- An assessment of the **Financial Conglomerate Directive** due by 31 December 2012 should propose full participation of the relevant supervisors of those developing countries where the conglomerate concerned plays a significant role.
- New mechanisms should be designed to make all those implementing supervisory tasks **accountable to parliaments** and to the public at large. This would allow parliaments and citizens, to draw attention to the impact on developing countries.

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\(^{15}\) See such as arrangements as the ‘Concordat’ agreed by the Basel Committee on Banking Supervision (www.bis.org/bcbs).
and overall help to avoid that mistakes in supervision can lead to spending huge amounts of tax payers’ money.

- The ESRB should redefine ‘systemic risks’ to also cover risks beyond the EU and therefore give a high level expert from a developing country a seat in the Advisory Scientific Committee.

- Systemic risks should also be defined by the ESRB as risks for sustainability and society (e.g. the poor having no access to financial services, too little credit for sustainable activities and too much lending to financial speculative activities and products, etc.).

- Many developing countries have problems assessing new complex financial products and practices introduced by foreign banks. All supervisors should have a mandate to assess all new financial products and practices designed, sold and used by banks (‘a financial product safety authority’). If a financial innovation is judged to have a negative impact of financial and social stability, it should be banned.

### 2.2. New banking rules in the EU

The financial crisis revealed that bank regulations needed an overhaul to avoid banks destabilising the financial system, the economy and governments’ budgets. Huge amounts of tax payers’ money was needed because the banks lacked the necessary capital reserves to avoid destabilising bankruptcies. Therefore, a major EU bank reform redefines how much capital a bank must hold as a reserve. These so-called ‘capital requirements’ should allow banks to deal with defaults from borrowers and with losses from activities on financial markets. International guidelines about capital requirements are set by the Basel Committee on Banking Supervision. The current capital requirements, called Basel II (see below), also include rules how banks should assess the risks of borrowers and how they should be supervised. The Capital Requirements Directive (CRD) is the EU law that has made Basel II legally compulsory for EU based banks.

#### 2.2.1. Banking rules that the EU has already reviewed

The EU already made some changes to the CRD to deal with the most obvious problems that caused the financial crisis, resulting in CRD 2 and CRD 3 (decided in 2009 and 2010 respectively), with improved regulation regarding:

- Reducing risky (re-)securitisation by banks. Securitisation was a major cause of the financial crisis whereby banks were selling off loans of low quality (‘sub-prime’) to...
others through complex non-transparent financial products, in order to avoid capital requirements.

- Banks that are holding securitised products need to be more transparent about the risks and meet higher capital requirements.
- Inter-bank lending is being limited to avoid that banks are too dependent on each other for their daily working capital which created problems during the financial crisis.
- New regulations reduce excessive remuneration and bonuses of bank staff, e.g. between 40% to 60% of any bonus payment must be delayed for at least three years\(^\text{17}\) as a way to reduce short term incentives to take too many risks.
- Banks need to improve the risk assessments of their speculative and risky activities on financial markets (e.g. derivative trading) and build in higher capital reserves.

These newly imposed regulations do not stop the risky practices by banks and their non-transparent off-balance related activities. By limiting inter-bank lending, potentially developing countries might receive fewer loans as they are seen as too risky.

### 2.2.2. CRD 4: better and higher capital requirements

On 20 July 2011, the European Commission (EC) presented its legal proposals, commonly called CRD 4, to improve the quality and quantity of the capital that European banks need to set aside (capital reserves) and to improve bank governance.\(^\text{18}\) These EC proposals have to transpose into EU law the new international capital requirement standards that were agreed at the end of 2010 by the Basel Committee of Banking Supervision and the G20, called Basel III.\(^\text{19}\) The CRD 4 proposals consist of a set of two different EU laws:

- A Regulation\(^\text{20}\) on stricter capital reserves to be held by banks, which requires:
  - Improved quality of the capital reserves, through 14 stringent criteria, so that this capital can be used when a bank is in financial trouble.
  - An increase in the quantity of the newly defined high quality capital reserves that financial institutions need to hold (up to 7% of their risk weighted capital).

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\(^\text{20}\) ‘Regulation on prudential requirements for credit institutions and investment firms’: An EU regulation needs to be implemented immediately with little or no text changes once agreed by the European Parliament and the Council of Ministers of Finance.
Procedures to improve the reserves and management of easily available money (liquidity) to withstand sudden huge demands of cash in a short time period. The final liquidity rules will be set by the EC in 2015. Rules on how a bank manages its ‘stable’ and long term funding will only be set by the EC in 2018.

Improved risk management by stricter prescription of how banks and investment firms need to calculate and mitigate the risks of their activities. These calculations define how much capital reserves banks need to hold, especially when they engage in risky activities such as derivatives trading and lending to hedge funds.

A Directive to improve the supervision and governance of banks, by:

- A mandate to supervisors so that they may require banks to hold additional capital buffers (‘a countercyclical buffer’) in booming economic times to be used in bad economic times. Supervisors can also require additional capital reserves to be held by large financial institutions that are highly risky for the financial system (systematically important financial institutions: ‘SIFIs’) for whom standards of extra capital buffers still have to be regulated.

- Improvement of corporate governance of banks and investment institutes through new criteria on how banks are managed and how they improve their risk management or risk assessment processes, including reducing their dependence on credit rating agencies. Also, supervisors will have to apply sanctions in case of violation of EU banking laws.

- Lowering the amount that banks borrow themselves (leverage). A borrowing limit, or leverage ratio, will become binding in 2018.

The overall approach taken by CRD 4 is mainly to limit, without too much costs for banks, financial risks and financial instability that can affect the functioning of the financial system and the economy, especially in the EU. The CRD 4 impact assessment by the EC did not look into the effects on developing countries where European banks are operating. The interconnectedness between banks worldwide and between international banks and risky financial markets has not yet been reformed. For instance, no separation between retail and investment banking activities have been proposed e.g. as part of the proposed capital requirements’ review for bank’s activities in risky derivatives markets and for lending to hedge funds.

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21 Any EU Directive first needs to be transposed into the national legislation of EU member states, which are allowed to make slight national variations in the directive, before it is being implemented at national level.


23 See the impact assessments made by the EC at: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#crd4.
While more financial stability is indeed important for the entire banking system, the EC reform proposals are in no way geared towards making the system more efficient in economic, social and sustainability terms. They do not guarantee that banks will be able to meet the financial needs of society, including those of citizens most in need of basic financial services and loans. Nor will the reforms engender bank financing for transformations towards more environmentally and socially sustainable economies. For instance, the CRD 4 proposals fail to seriously overhaul the risks assessment systems used by many European banks which currently give insufficient weight to social and environmental risks and benefits when assessing loans.

The proposed bank reforms have failed to tackle the banks’ business model of maximising profits for shareholders, used to attract investors but resulting in a driving force for too risky behaviour by banks. European banks have already lobbied against higher capital requirements, which they argue will be so costly that it will result in less bank loans to small and medium enterprises since these are considered less profitable. In addition, the turmoil of the Euro and governmental bonds in 2011 have shown that banks are in urgent need of more capital, but investors and financial markets are reluctant to invest in unstable banks. For developing countries, the lack of capital at European banks might result in less lending by European banks operating in these countries, to local SMEs and poorer clients, and more focus on rich clients. European banks might also sell off their less profitable subsidiaries/branches in developing countries, which might cause instability. On the other hand, in order to re-capitalise and make more profits off new rich clients, European banks are expanding in highly profitable (emerging) market countries, such as India, including through acquisitions.

**Recommendations regarding CRD 4**

The following recommendations deal with important flaws in the EC’s CRD 4 proposals:

- Before agreeing on CRD4, the EC, European Parliament and the EU Ministers of Finance should carry out a **new impact assessment** that covers the potential impacts of the CRD4 proposals on developing countries as well as on different social and environmental aspects.\(^{24}\)

- The EU should **forbid ‘proprietary trading’**, whereby the bank is trading in risky and speculative financial markets on its own risk and with its own money. The proposed measures on risky activities by **banks in derivatives markets** and towards hedge funds and private equity should be much more prohibitive. To avoid unstable banks active in developing countries, serious proposals should be made to separate basic retail banking from risky investment banking.

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Proposals, which are still being developed by the EC\(^25\), to deal with crises or bankruptcy at European cross border banks, should ensure that not only **savings and basic services** for European clients are secured but also for those in developing countries.

The EU should introduce guidelines for **responsible lending**\(^26\) in home and host countries world wide, to prohibit unethical lending to very poor customers\(^27\) and poor countries\(^28\).

In order to promote environmental and socially responsible financing and a diverse financial sector, new EU CRD 4 rules should **reduce the current high capital requirements imposed on small cooperative and ethical banks when they lend to non-risky socially and environmentally friendly activities**.\(^29\) Other extra measures should reverse the current trend of more identical and concentrated banking systems, partly due to banking standards.

Bank reforms should result in banks that primarily service the economy and society, not the financial markets nor focus on the rich and large corporations. CRD 4 rules should include **new credit risk assessment systems** so that banks provide funding for the transformation towards more socially and environmentally sustainable production and consumption, as well as for many social needs of society.

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\(^{25}\) See for instance: proposals to deal with banks in crisis (http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm) and the review of the system that guarantees that savers get their money back (to a certain extend) in case of bankruptcy (Deposit Guarantee Schemes) (http://www.europarl.europa.eu/oeil/file.jsp?id=5865122).

\(^{26}\) The EC has so far only introduced a proposal for responsible mortgage lending: see http://ec.europa.eu/internal_market/finservices-retail/credit/mortgage_en.htm.


3. The crucial role of credit rating agencies for developing countries overlooked

The great extent to which banks and other creditors, as well as investors, financial markets actors, speculators and even supervisors, use credit rating agencies (CRAs) to assess the creditworthiness and value of companies, bonds, financial products, etc. is often underestimated. These agencies are private profit-making companies that service the many financial operators and investors who lack the capacity to carry out their own full risk assessments. The rates that CRAs decide on determine how lenders and investors will behave and to whom credit or capital will be provided.

Credit ratings are important for developing countries because they help Western creditors and investors see what investment opportunities and financial viability these countries have. A CRA rating of the creditworthiness of a developing country impacts on the cost of borrowing: the lower the grade/rating, the higher the interest rate a developing country government or a company needs to pay for a loan, or the higher the level of interest (coupon) that a country needs to pay when issuing a bond. CRAs often do not rate (smaller) developing country companies that cannot pay the high rating fees so that these companies miss access to international credit and investment flows. CRAs influence developing countries’ economic policies because the threat of being downgraded results in some governments favouring investor-friendly free market policies over indigenous efficient policies which might not suit foreign investors. Capital rapidly flows out of a developing country after a ratings downgrade while inflated ratings may lead to a credit bubble. Both are highly destabilising.

There are various other problems with ratings of developing countries by CRAs. These ratings are often of a lower quality because CRAs devote less staff to it and use only a few of the indicators in their rating catalogue, with GDP per capita, growth rates and inflation being the most important. A limited number of criteria makes it difficult to fully assess the risks or creditworthiness of a company or country. Companies and regions within a developing country can rarely obtain a better rating than their government, irrespective of their real creditworthiness. Overall, by influencing how much capital is flowing to developing countries and their companies, CRAs affect the destiny of a whole country.
3.1. The failures of credit rating agencies

The financial crises of 1997 and 2008 have exposed how CRAs have time and again failed to accurately assess the risks of borrowers and financial products. CRAs incorrectly gave high grades to complex securitised mortgage products, which facilitated their sale all over the world but then became an important cause of the 2008 financial crisis.

CRAs ratings have been incorporated into legislation, for instance to determine what kind of financial products an institutional investor or insurance company can hold. Basel II standards require that banks with no full risk assessment mechanisms of their own, have to use CRAs based on strict selection criteria. Many developing country banks currently still use CRAs. But CRAs are currently not legally liable for their mistakes. One reason for incorrect ratings is that the CRA industry suffers from conflicts of interest and a culture of high bonuses. Since borrowers and issuers of financial products pay to be rated, they shop around to see which CRA gives them the best rating. This incentivises CRAs to inflate ratings in order to get business deals.

3.2. Reforms of credit rating agencies incomplete

Not until 2009 did the EU start to regulate CRAs by imposing certain conduct which CRAs are required to apply as of December 2010. The CRAs are required to:

- register (and only registered CRAs can be used by European firms);
- apply particular rules to conduct their business conduct rules and reduce conflicts of interest;
- be more publicly transparent about their rating methodology and record.

At the end of 2010, additional CRA regulations amongst others ensured efficient and centralised supervision of CRAs at EU level through the European Securities and Market Authority (ESMA).

Since Spring 2010, sharp and sudden downgrading of ratings of EU member states by CRAs due to high indebtedness (first Greece, then Ireland, Portugal, Spain, and by October 2011 Italy and France) resulted in these countries having to pay very high interest rates for loans and bonds. This exacerbated the economic crisis and the Euro governance crisis, as well as speculation against the Euro and European banks. EU institutions have subsequently acknowledged CRAs needed to be further reformed. In

For more information, see:
November 2010, the EC launched its first ideas through a public consultation\textsuperscript{31} 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.
- Inadequate methodologies to rate government debt.
- An effective oligopoly of three large CRAs\textsuperscript{32} that internationally dominate the complex ratings business, 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 when the borrower or issuer of a financial product pays for the rating.

The EC’s proposals for a legislative proposal with solutions to the above structural problems is being published at the end of October 2011.

3.2. Recommendations to deal with deficient CRAs

Apart from effectively regulating so solve the above mentioned structural problems, the following proposed reforms would benefit developing countries and sustainable development world wide:

- Highly improve the quality of CRA ratings by imposing additional criteria to the methodology and process of rating, such as assessing a range of social and environmental impacts\textsuperscript{33} and assessing macro-economic instability risks so that no costs will be paid by society.

- Public and/or private initiatives could improve the ratings by:
  - Supervisors and Central Banks publishing their own ratings on all asset classes;
  - An independent but government sponsored well supervised European Credit Rating Agency (ECRA) that could play a role in setting (a higher) standard in the market;
  - Sanctions by supervisors and the court for ‘gross negligence’ and the use of too limited criteria that lack sustainability assessments by CRAs;
  - Obliging a second rating by a CRA which is identified and allocated by a supervisor.


\textsuperscript{32} Fitch, Moody’s, Standard & Poor’s.

\textsuperscript{33} 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-coulor rating system to rank environmental impact assessments. Indeed, environmental damage such as the oil spill of BP or social unrest when human rights are breached by mining companies, 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.
Developing countries governments and companies should get **guaranteed access to high quality ratings and other assessments methods**, through compulsory rating or, if need be, through non commercial agencies and aid budgets.\(^{34}\) Also, the EU supervisor of CRAs, ESMA, should provide 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 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 a clear definition 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.

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\(^{34}\) 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.
4. Financial markets: still highly risky

The huge volumes of money which move around the world in search of the highest profits have an enormous influence on the financial system. Capital flows, products and actors on financial markets have played an important role in creating and worsening the financial crisis in the EU, which still continues as of October 2011. This chapter covers issues and EU reforms in those financial markets that have an important impact in developing countries:

- Derivatives markets in commodities and foreign exchange
- Hedge funds and private equity funds
- The Financial Transaction Tax (FTT)
- Secret tax havens

4.1. Derivatives markets: speculation on food and currencies

Developing countries can be affected by derivative trading, as explained below, because commodity derivative trading influences the prices of many of the products developing countries export or import, such as wheat, soy, maize, sugar and other food products; coffee, cocoa and other agricultural commodities; oil and gas; gold, tin and other metal commodities. Foreign exchange derivatives also affect the value of developing countries’ currencies. The instability of the value of foreign exchange of many countries throughout 2010 and 2011 – a major point of discussion at the G20 – influences, and is being influenced by, speculation with foreign exchange derivatives (e.g. foreign exchange swaps).

Derivatives are contracts that place a bet on the change of value of the underlying products (e.g. commodities, currencies), events (e.g. increase in interest rates, default on a loan), etc. Derivatives, such as futures and options, can be used for purely ‘hedging’ purposes, i.e. to transfer the risk of price instability to a market participant who is willing to bear this risk. Derivatives are however increasingly used in a highly speculative manner. Derivatives permit gambling on price changes of a given product without actually having to buy and invest in that product market, which would require a large outlay of cash. Moreover, speculators can borrow money so that they can quickly build up an enormous exposure to a market while putting down only a small amount of their capital. The huge profits made in derivatives trading have resulted in the payment of high bonuses and more incentives to speculate, making big financial actors to enter these markets, especially large investment banks.

A major problem, also for developing countries, is that 90% of derivatives are traded bilaterally ‘over the counter’ (OTC) in non-transparent ways so that price movements are difficult to analyse, e.g. price movements of OTC foreign exchange derivatives trade. The global OTC market reached $ 601 trillion by the end of December 2010 (notional amount
Agricultural commodity derivatives trading occurs to a significant extent on exchanges that publicly report on prices. These prices are then used as price benchmarks by developing country importers and exporters, even though developing countries have no control over such exchanges (e.g. Chicago Board of Trade (CBOT)). Commodity and foreign exchange derivatives trade constitute a relatively small part of overall derivatives trading, but its functioning and volatility has had serious consequences in developing countries.

In the years leading up to mid 2008, more and more institutional investors and speculators had invested in commodity derivatives and related investment products (e.g. commodity index funds), hoping to get higher profits than in other markets. Huge commodity price rises on derivatives exchanges followed with a peak in June 2008. This resulted in developing countries have to pay high prices at which to import their food and energy. Food riots in 25 countries followed and millions went 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. Although it is disputed how large the role of financial actors is, it becomes more and more clear that they play a role in the increasing volatility.

This was also visible in 2010 and 2011 as commodity prices suffered huge price swings while financial actors dominated the commodity derivatives market. Speculators and institutional investors have invested again in commodity derivatives since 2009. The manipulation of the London cocoa derivatives market by a hedge fund resulted in huge price increases in the summer of 2010, which made even chocolate producers speak out against the lack of regulation.

Foreign exchange derivatives are being sold to exporters in developing countries. Because the risks were not explained clearly and/or because of unexpected movements in foreign exchange, exporters in developing countries lost huge sums in recent years. This was the case in Brazil in 2008, and also in India where a number of exporters in Tirupur may well go bankrupt and make many workers unemployed.

Various large or advanced developing countries have important commodity and currency derivative markets. India was able to introduce a ban on food derivatives trade when the prices were very high. In contrast, South Africa could not do so as it had

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37 Ibidem.


committed under free trade agreements to keep derivatives trade open to the dominating foreign derivative trading firms.

4.1.1 The start of an EU regulatory regime

- In September 2010, the European Commission (EC) presented its first proposals\(^{40}\) to regulate the derivatives market, which had since long been liberalised at an EU level without any EU regulation or supervision. This European Market Infrastructure Regulation (‘EMIR’) was still being discussed by the EU Council of Finance Ministers and the European Parliament at the beginning of October 2011. This new EU legislation especially regulates the non-transparent over-the-counter (OTC) derivatives market and contains mainly the following elements\(^{41}\):
  - Increased transparency: OTC derivatives trade need to be reported to special data centres to which supervisors have access, while more general information will regularly be reported to the public. More OTC derivatives contracts will be obliged to be traded on exchanges.
  - Reduced risks: more OTC trades need to be cleared, i.e. using central counterparties that are strictly regulated by EMIR and guarantee payments in case one of the contracting parties defaults.\(^{42}\) Up to a certain threshold, so-called ‘non-financial parties’ will not have to clear.
  - The newly created EU regulators-supervisors (European Securities and Markets Authority, ESMA) receive a mandate to supervise and intervene in times of turmoil.

- By mid-October 2011, the EU was still finalising a new legislation to restrict (but not ban) particular abusive practices in derivatives markets, namely \(^{43}\) ‘(naked) short selling’, i.e. selling securities that a speculator does not own but which can manipulate prices and provide huge profits, e.g. on currencies.

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\(^{42}\) In technical terms: Especially ‘standardised’ OTC derivatives will need to be 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 by EMIR. In addition, new risk mitigation techniques are to be applied to non-cleared OTC derivatives.

\(^{43}\) This relates especially to speculating with CDS (that insure against a default by a governmental on its bonds) without owning the bonds: this happened 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). For all details of this regulation on short selling and certain aspects of credit default swaps, see: http://www.europarl.europa.eu/oell/file.jsp?id=5872692.
On 20 October 2011, a long awaited legislative review proposal of the Markets in Financial Instruments Directive (MiFID) was proposed by the EC. MiFID regulates financial markets (e.g. exchanges), trading practices and investment (advisory) services and related financial products (including derivatives), suppliers and marketing practices. The aim of MiFID is to protect the interests of investors (e.g. to get the best prices) and the integrity of the financial markets, as well as ensure that investment services operate in one single free market.

The EC proposed that the review of MiFID results in two legislations:

- A regulation (the Markets in Financial Instruments Regulation - MiFIR) that especially aims at more transparency for financial traders and their supervisors who get more powers to stop certain disruptive services or trading, and more OTC derivatives being traded on regulated trading platforms.
- A reviewed directive, MiFID II, aims to regulate all forms of ever changing trading practices in derivatives on exchanges and other trading platforms - including commodity derivatives trading -, to ensure more transparency of all trading. It would also ensure more powers to supervisors to intervene in derivatives trading and contracts, and to impose sanctions.

This legislation was expected to impose on financial speculators in food commodity derivatives markets. However, the EC’s proposals do not make any specific reference to trade in food derivatives nor interventions against excessive speculation on food prices. According to the proposals, the EC will decide on limits of how much commodity derivatives contracts a participant on exchanges or trading platforms can hold. National authorities will need to have the capacity to ensure that limits are being enforced and that they can intervene when markets are not functioning orderly or abused. Because of loopholes in the EC proposal, the further EU decision-making process will be important to ensure that speculation is at least reduced.

The EC has also made proposals to review the Markets Abuse Directive (MAD) at the same time of MiFID. One of the aims of the reviews is to also cover commodity derivatives markets.

Another review is due to be released in late 2011 of the directives on Undertakings for Collective Investment in Transferable Securities (UCITS). This review is important from a development perspective because commodity investment funds, such as commodity index funds, are trading in commodity futures and can influence prices of agricultural futures that are benchmarks for food export and import prices for developing countries.

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4.1.2 Recommendations to improve EU legislation on commodity derivatives

Because the EU legislative proposals are very timid, contain many loopholes and do not tackle some fundamental problems, the following recommendations propose ways to ensure a strong EU legislation, especially in MiFID, to stop and prevent excessive and harming speculation in food commodities and foreign exchange derivatives markets.

- **Introducing the precautionary principle** in regulations to prevent rather than repair food commodity speculation and foreign exchange speculation. In order to guarantee the right to food, EU legislation should explicitly aim not only to prevent risks to financial systems but also harmful effects to the wider society, such as on food and energy supplies all over the world. This should be included in a clear definition of disorderly functioning of markets, on the basis of which supervisors can intervene strongly.

- **Limits on, and bans of, financial speculative participants** in (agricultural) commodity derivative markets and foreign exchange markets should be incorporated in the legislation and not only be left to supervisors to intervene. These ex-ante limits and bans should be clearly defined (volume, period of the limit, price limits, etc.).

- **Strict definitions** of ‘end-users’ who are hedging for business, and ‘financial participants’ who speculate so as to prevent abuses. All participants should also report themselves on what kind of activity they are undertaking (as is the case in the US: hedging or speculating).

- **Strong supervision**: Supervisors will need to be well resourced to intervene in huge, expanding, complex and increasingly swift-moving commodity derivatives markets, and to stop excessive speculation and abusive practices. Especially, there should be close institutional links, or a special body, to cooperate with supervisors and regulators of physical commodity markets. If supervisory budgets are too small for these tasks due to governmental budget cuts, the commodity trading should be limited and no OTC commodity trade allowed. Authorities and stakeholders from developing countries should to have access to the EU supervisory bodies.

- **Greater transparency**: Relevant information about all EU commodity and foreign exchange derivatives trades should be published weekly to the public in an accessible way.

In general, EU legislation should not be less strict than in the US (Dodd-Frank Act) and avoid ‘regulatory arbitrage’ by financial speculators using EU commodity derivatives markets for activities that are forbidden in the US. The usefulness of the whole derivative market for the economy and society is in doubt, certainly given their disorderly functioning and effects on the crisis of the Euro and EU banks. Shrinking destabilising and socially useless derivatives markets should be the overall objective.
4.2 New regulation of hedge funds and private equity: poor benefits for developing countries?

Most EU authorities argue that so-called ‘alternative investment funds’ (AIFs), such as hedge funds and private equity funds, 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 account for more than 50% of the actors in speculative financial markets. These actors typically operate in a non-transparent way based in tax havens, and use super speedy computers and other techniques that make them price drivers. By producing very high returns, profits and bonuses, AIFs were creating unrealistic expectations about high financial returns elsewhere in the financial markets and business world. AIF’s high amount of investments and interconnectedness with the rest of the financial industry, based on a strategy of using huge levels of borrowing, were an important cause of the financial crisis and accelerated the spread of the crisis in 2008. By mid 2011, hedge funds were estimated to manage around €2 trillion in assets worldwide.

For developing countries, AIFs are important because they are becoming increasingly active in advanced developing countries where they attract wealthy individuals to invest in their funds. AIFs are making high returns off developing countries in the following ways:

- Hedge funds are very active buying and speculating in derivatives markets, including in (agricultural) commodity derivatives and foreign exchange derivatives – contributing to price bubbles and price crashes (e.g. in May 2010 and May 2011).
- Hedge funds are creating, offering, operating and investing in all kind of commodity (index) funds and investment products that (partly) speculate in food, oil and metal prices.
- Some hedge funds invest 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.
- Private equity funds invest in, and buy up, companies in developing countries, by borrowing much more money than they own (‘high leverage’). They then offload the high debt to the company they bought and use all kinds of cost cutting strategies, including lay-offs, to repay the debt (resulting in so-called ‘asset stripping’).
- Private equity funds often have a very short term interest in making high profits and sell companies they bought after a short period of time. However, in times of financial crisis they have trouble to pay off their debts as high profits at the companies they bought, are elusive.

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New EU regulation

After much heated debate, the European Parliament finally agreed on 11 November 2010\textsuperscript{49} to regulate the so-called alternative investment funds (AIF), 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\textsuperscript{50} of the new EU regulation are:

- Registration: EU based AIFM who manage more than $\text{€} 100$ million (including leverage) have to register and apply the new regulations; not all AIFM will have to apply the Directive in full.
- More transparency: mandatory reporting of AIFM activities to the public, to employees of companies that private equity funds own, to investors and to competent authorities.
- Requirements to hold a minimum of capital reserves.
- Remuneration principles: binding rules on remuneration of the AIFM and their employees, to avoid too high and risky levels of loans, as well as restrict abusive practices such as ‘short selling’.
- Regulation of how AIFM operate risk management;
- New supervision rules allow (but do 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’.

Comments from a developing country perspective

The new EU regulation is not changing the basic strategies and functioning of hedge funds and private equity. These highly speculative strategies have proved to be risky, harmful and sensitive to crises, namely by searching for the highest short term profits and using huge amounts of debt (‘leverage’). The AIFMD still has many shortcomings and loopholes\textsuperscript{51} which will limit its impact on reducing the risks the AIF pose to the financial system, to the companies in which they invest and to societies worldwide. The AIFMD will not stop hedge funds from investing in commodity derivatives. As is already clear from figures in 2010 when hedge funds increased their control of the soybean market to 19%, up from 13% in 2009\textsuperscript{52}, hedge funds are again hugely investing in agricultural commodity markets. As this


\textsuperscript{50} For more details, see Newsletter –EU financial reforms, Issues nr 2,3 and 4: to be viewed and downloaded at http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletters.


\textsuperscript{52} E. Moya, “Field of Dreams: Hedge Funds Put Faith in Grain”, The Guardian, 19 October 2010.
Speculative investment is linked to rising prices for foodstuff imported by developing countries, this is likely to directly or indirectly increase hunger among the poorest.\(^53\)

The new EU rules on hedge funds and private equity, together with the current low returns on investment and crisis in the EU, might turn even more AIF to developing countries. If not well regulated, AIF can cause many problems and increase financial and economic risks in their hosting countries, withdrawing huge profits out of developing countries while not providing more capital or long term investments.

There is a need for all institutions of the EU as well as the member states, academics and civil society to monitor 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 to consult authorities from developing countries and have channels of communication to receive complaints by employees, civil society and developing country stakeholders about AIF behaviour. The EU should provide sufficient support and (financial) means to improve regulation of AIF(M) in developing countries and provide for cooperation with ESMA. Whenever harmful practices become apparent, swift action should be taken to review the AIFMD.

### 4.3. A new and official proposal to implement a financial transaction tax (FTT) in the EU

Although banks and the financial sector have received trillion of dollars in direct and indirect support from taxpayers, the financial sector has been notoriously under-taxed compared with other sectors. Many civil society organisations in the EU and worldwide have been arguing for years in favour of a FTT that would impose a minimal tax (0.02 % for example) on financial transactions.\(^54\) This would allow financing of sustainable development needs in developing countries. France and Germany, and recently the European Commission (EC) have recognised that an FTT would provide extra income to their budgets, extra finance to deal with the crisis, and reduce public and social spending cuts.

After long discussions\(^55\) at EU level and notwithstanding strong opposition from the UK, the EC has proposed on 28 September 2011 to introduce a FTT at the EU level. In addition, the EU still attempts to convince G20 members to implement an FTT at a global level as that would make the FTT more effective. However, the US and others are strongly opposed,

\(^{53}\) 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.


Financial markets: still highly risky

including developing countries who do not want to burden their financial sector that after all did not cause or contribute to the financial crisis. Others like Thailand are considering introducing a FTT to reduce ‘hot money’ flowing into the country from, amongst others, the US and EU monetary and stimulus policies (e.g. ‘quantitative easing’).

The EC believes the FTT could generate up to over € 57 billion in revenues each year from 2014 onwards, but could lose money if some financial transactions would be re-located – which the EC does not see as a problem if these transactions are highly technical speculative practices.

The cornerstones of the EC proposal

- Trade in shares, bonds and other similar instruments will be taxed at 0.1%, and trade in derivatives taxed at 0.01%. Both trade on exchanges and over-the-counter (OTC) will be taxed, as well as structured products but the issuing of shares and bonds will not be taxed.
- Currency transactions will be excluded from the tax, not the derivatives based thereof.
- The tax will be applied to any financial transaction carried out by a broad range of financial institutions that are established in the EU, not transactions by citizens.
- The tax will apply irrespective where the counterparty of the transaction is located.
- Measures will be adopted to prevent evasion or avoidance of the FTT.

Some comments from a developing country perspective

The tax rate is still low and might be insufficient to eliminate all useless speculative transactions. The possibility for member states to increase the tax rate should provide an opportunity to use the tax to stop excessive speculation during times of turmoil on financial markets. However, the best way to stop excessive capital flows and disorderly capital markets would be to introduce control capital controls, which is not officially discussed and hardly allowed under the EU constitution or EU trade and investment treaties. There are still loopholes in the EC’s FTT proposal, which might result in strategies to avoid the tax. It is not clear whether the income for EU states and the EU will benefit developing countries although the option is not excluded.

There is still a lot of opposition against an FTT within the EU and by the EU’s G20 partner, as well as by the financial sector itself. Many challenges will need to be overcome before implementation, but there are strong campaigns by civil society in favour.

4.4. Developing countries and citizens lose out to secret tax havens

Tax evasion and capital flight deprive developing countries governments from income they need for serving the public interest and sustainable development. Incomplete tax collection in and illicit financial flows from developing countries are estimated to be between $250 bn and $900 bn every year. Indeed, many financial and other companies that also operate in developing countries use tax havens and secret jurisdictions to evade and avoid taxes. Also affluent individuals and corrupt politicians, including from developing countries, use these secret off shore jurisdictions to pay as little taxes as possible.

During the 2008 financial crisis, it became clear that many banks and investors have secret company parts or the official company seat in tax havens. However, the secrecy laws of tax havens make a large part of the risky products and capital flows non-transparent and non-supervised. This prevents supervisors from foreseeing a crisis and can worsen an ongoing financial crisis.

European countries and the G20 declared in the course of the first year after the 2008 crisis that they would strongly tackle the secrecy and tax dodging that tax havens are facilitating. However, since many G20 and other rich countries themselves have secrecy jurisdictions or legislation that facilitates tax evasion, many reforms did not take place.

At the EU level, the following initiatives were taken in relation to taxation and tax evasion in developing countries.

- A legislative revision of EU’s Savings Tax Directive aims at making current loopholes disappear. The proposal for revision had been issued on 2008 but final decision making has been extremely slow. A new Savings Tax Directive would ensure that automatic information exchange arrangements among tax authorities do not only cover to individuals but also to all legal entities, including trusts, and certain entities situated outside the EU.

- As part of a series of related documents, the EC’s Communication on Tax and Development in April 2010 was backed up by a June 2010 European Council “Conclusions on tax and development”, which all called for transparency and information exchange measures to stop tax evasion in developing countries as well as assistance to developing countries in building “efficient, fair and sustainable tax systems and administrations.” The European Parliament published several strongly worded resolutions in 2010 and 2011, which among others called for several international mechanisms that curb tax evasion and avoidance worldwide, and for tackling ‘transfer mispricing’ that allows untaxed money to flow out of developing countries.

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60 For general information about this issue, see: http://www.taxjustice.net/cms/front_content.php?idcatart=2&lang=1;
Following the above 2010 EC communication, the EC has been exploring ‘country-by-country’ reporting whereby companies need to disclose how much tax they pay in each country they operate. In 2010, the EC held a public “Consultation on Financial Reporting on a Country-by-Country Basis by Multinational Companies”. Country by country reporting is a longstanding request by civil society organisations. No follow-up communications were published as of mid October 2011 notwithstanding that the EU Competitiveness Council in March 2011 called upon the EC to come forward with initiatives on the disclosure of financial information by companies working in the extractive industry, including the possible adoption of a country-by-country reporting requirement.

Recommendations to avoid tax evasion and secret financial flows

Since the claimed strong commitment in 2008 to tackle secret tax havens and jurisdictions has been disappearing in 2010 and 2011, stronger actions and basic requirements need to be taken to avoid that part of the financial sector’s capital flows and financial products remain non-transparent (shadow banking) and to stop tax avoidance and evasion, especially for developing countries. The following measures are some of the demands that have often be made by civil society, but have not yet been put in place:

- Concrete measures to clamp down on tax havens or the methods they use to guarantee secrecy, and to make information public.
- A full fledged international mechanisms for automatic sharing of information between tax authorities should make it more difficult for rich people and companies to hide fortunes and pay (almost) no taxes.
- Extra assistance or funds should be provided to strengthen developing country revenue authorities.
- Strong requirements should be enforced on companies to publish precise reports with disaggregated and detailed tax information, country by country, which covers a comprehensive range of data on a company’s activities, project and type of payment to governments.
- Banks nor any (financial) company should be allowed to hold off balance sheets or use other methods to keep part of the financial flows and products non-transparent.

For more information see:


See for instance overviews at the website of Eurodad, Tax Justice Network and SOMO:
http://www.eurodad.org/debt/?id=2192&page=0&ReportShowall=true#reports;
5. The EU’s internal and external financial, monetary and economic governance

5.1 Lack of reform in EU decision making processes

The financial crisis revealed how the EU had applied freedom of capital movement and free movement of financial services, whereby cross-border banks and financial conglomerates moved freely in EU countries, while failing to institute a parallel regulation and supervision at the EU level out of fear that governments would lose sovereignty and competitive advantage. Worse, the increased competition among the financial companies in 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 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 competitiveness has been and still is 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 different from what the EC proposes. Before each decision making step, official and informal consultations take place with the financial sector which is lobbying heavily and successfully so that its interests get more incorporated in the laws than those of civil society, let alone those from developing countries. All these political processes are long and burdensome and based on compromise which prevents swift action and strict regulation. The meetings of heads of state, as well as bilateral meetings between president Sarkozy and Chancellor Merkel, have become decision-making forums especially to deal with the Euro crisis and are far from democratic processes. Worse, these meetings have resulted in decisions that

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67 For full details how the decision making process worked until Autumn 2008, see: M. Vander Stichele, Ibidem.
actively undermine democracy by imposing how much a public budget deficit can be and that wages need to remain low.\(^{68}\)

However, there are little to no discussions and proposals on how to overhaul this EU decision-making model. Moreover, the processes are so EU focused that the EU financial reforms pay little attention to the needs of or impacts on developing countries. The lack of coordination among member states at the time of the crisis in 2008 resulted in some stimulus measures by EU member states that were harmful to 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. In 2010-2011, many EU member states are cutting their budgets without any coordination nor special consideration of harmful effects on poor developing countries.

### 5.2. The EU, its member states, and international financial and monetary decision making

The financial sector reforms described in this report have mostly been part of what has been agreed at the international level, i.e. G20, although G20 decisions do not go beyond what EU members are willing to agree to. What is special about the EU is that only a few EU countries are member of all the international bodies where the financial sector reforms are being decided. The EU as such has no official representation in some of these bodies.\(^ {69}\) This contrasts with the EU’s single voice with which it negotiates liberalisation of financial services through free trade agreements, an issue which is not on the agenda of the G20 (see below). Developing countries who sit in international bodies to decide on financial sector reforms – and many small or poor developing countries are not represented – thus deal with different parts of the EU for instance at:

- The G-20\(^ {70}\)
- The Basel Committee on Banking Supervision
- The Financial Stability Board

The EU member states have been actively manoeuvring to ensure that the international financial and monetary decision-making process was established at the G20, and not the UN where all developing countries, and EU countries, have a voice. The EU hardly took

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\(^{68}\) For more details, see for instance: P. Wahl, “EU-Crisis Management - More Europe or more Germany?”, Newsletter – EU financial reform, nr 8, September 2011, http://us2.campaign-archive1.com/?u=de91cc688ad2982e33685a883&id=cf531a778d&e=#mctoc3.


\(^{70}\) Twelve large developing countries are part of the G20: Argentina, Brazil, China, India, Indonesia, Mexico, Saudi-Arabia, Turkey, South-Africa and South-Korea.
note of the report\textsuperscript{71} 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 became the only international forum where decisions on financial reforms take place even though it is an informal body with no legal powers and is supported by the work of different international bodies such as the IMF. The EU Ministers of Finance prepare beforehand the EU position at the G20, which is represented by the European Commission. There are G20 issues which are difficult for the EU to agree on, namely (1) the issue of international monetary and currency policy – given the turmoil around the Euro governance –, and (2) the issue of capital controls because the Lisbon Treaty (Art. 63-66) only allows temporary interventions in the EU to restrict cross-border capital movements with third countries in exceptional circumstances after difficult procedures. However, capital controls have been increasingly used by G20 developing countries\textsuperscript{72} and have been increasingly acknowledged, even by the IMF\textsuperscript{73}, as a useful tool to protect a country against attacks from international and institutional speculators.

**Recommendations to make EU financial reforms more internationally responsible**

Since the European financial industry is operating worldwide, the EU should strengthen international decision-making on reforms of the financial sector and monetary system (‘the international financial architecture’) and make it more democratic by:

- **Having a strong commitment to cooperate at an international level to drastically reform the financial sector**, not only to ensure financial stability in the interest of the EU but to place the financial sector at the service of transforming economies and societies towards more socially and environmentally sustainable development, worldwide.

- **Reforming decision-making at the EU level** and regarding its representation at international fora where financial, monetary and economic reform and cooperation is decided.

- **Actively promoting that all developing countries’ interests regarding financial reforms are heard and taken into account, as much as possible at the 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.**

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\textsuperscript{72} K. Singh, “Will G20 take collective stand on capital controls?”, The Korea Times, 10 November, 2010: Brazil, Indonesia, South Korea.

Actively promote, and engage in, discussions on ways to **achieve a stable international currency system**, a stable role of the Euro and stable European monetary governance. For instance, a fund on each continent to deal with monetary problems or a regional currency should be explored.

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 an international level, apart from the use of an FTT.

### 5.3. Agreements on free trade in financial services undermine financial reforms

Without any coordination or discussion at the aforementioned international fora, the EU and many developing countries negotiate free trade and investment agreements that liberalise financial services. The previously mentioned ‘Stiglitz Committee’ has warned that financial reforms or anti-crisis measures were being undermined by specific rules in 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) and in bilateral investment treaties (BITs). Nevertheless, the EU continues to negotiate FTAs that 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. The EU pushes for ever-increasing market access for the European financial industry even if sufficient international, EU or national regulation and supervision are not yet in place (as is described above).

The FTA texts that are currently being negotiated, or that have been agreed upon after the financial crisis started in 2008, are based on the pre-crisis model of ‘light touch’ regulation, i.e. ensuring as little regulation as possible. GATS and FTA rules can prevent re-regulation in those countries that explicitly liberalise financial services under trade agreements, as inscribed in their list of ‘commitments’ attached to the agreement. Serious disciplines then determine how governments can regulate and treat foreign and domestic financial service providers and financial products, for instance:

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74. 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*.


76. See for instance, the EU – Cariforum EPA, the EU – South Korea FTA.

Countries cannot impose restrictions on the size and value of the operations of financial service providers. This GATs and FTA rule contradicts with different kinds of measures, e.g. to prevent excessive speculation in derivatives markets or to prevent banks becoming too big to fail. Moreover, the GATS and FTA rules on prudential regulation are not clearly defined as to what measures to the stabilise the financial system would be allowed.

Countries that made GATS and/or FTA commitments to liberalise financial services (providers) can only reverse those commitments if they pay compensation as requested. 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 and speculation.

GATS and FTAs also forbid, or strictly discipline, controls on capital or currency flows. Developing countries who sign FTAs with the EU lose the possibility to use capital controls to prevent a crisis.

In addition, the Lisbon Treaty has provided the EU with new competences to negotiate full investment agreements. In autumn 2011, the EU is discussing how such new investment agreements would impose high levels of protection to foreign investors, including those investing in the financial services sector and buying up domestic banks, which can be at the detriment of host governments’ policy space to re-regulate its financial sector.

Recommendations to coordinate liberalisation and reform of financial services

In order to deal with the contradictions between GATS/FTA rules and financial reforms or anti-crisis measures as well as provide more policy space to governments wishing to re-regulate the financial sector, the EU should:

- Put the GATS/FTA liberalisation of financial services on the agenda of international fora where financial reforms are actually decided. It should then be discussed how rules that liberalise financial services should be made to conform to international as well as national/regional financial reform decisions. This means that negotiations on trade and investment agreements that cover financial services should not be left to trade negotiators but become part of financial reform mechanisms and decision-making processes.

- The EU should at the very least not continue to negotiate liberalisation of financial services in GATS/FTAs until a full, open and participative assessment is made of the relationship between free trade rules on the financial crisis and financial (re-)regulation. Also, the EU should not continue to negotiate liberalisation of

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78 Compensation is paid to those countries who ask for compensation based on the estimate of the profit loss to their financial industry.

financial services before all necessary international and EU regulations and supervision are in place.

- The EU should allow developing countries to impose capital controls and all other measures needed to regulate the financial sector and prevent a financial crisis. In general, the EU should allow developing countries to withdraw their GATS/FTA commitments in financial services without having to pay compensation, in order to allow regulation of the financial sector.

- In case the EU continues to negotiate financial services liberalisation agreements, the EU should stop requiring its developing counter party to fully adopt Basel III standards if that country indicates these standards are not adequate for its financial sector. Rather, the EU should provide financial and human resources support to make regulation and capital requirements in developing countries most effective to their needs.
6. Concluding remarks

☐ Lack of vision
Throughout the overview of the selected EU financial reforms in this report, it is clear that the European Union lacks an overall vision of what the function of the financial sector should be, in the EU and elsewhere in the world.

The European Commission’s proposals for financial reform have not been based on a thorough analysis of what went structurally wrong in the financial sector. Nor was a link made between the financial crisis and other crises in the world, such as the climate crisis, the growing gap between rich and poor, or even the crisis of democracy in the EU – amongst others because of undue and powerful lobbying by the financial industry. The European Parliament’s report about the causes of the financial crisis and how solutions should provide better employment opportunities, for instance, was hardly echoed in the financial reforms. The neo-liberal structures that are incorporated in the Lisbon Treaty (e.g. free movement of financial services and free movement of capital) might have somewhat prevented the EU from taking new bold steps.

As a result, the EU financial reforms do not integrate and implement a model of a financial industry that is at the service of the economy and a sustainable society all over the world, in which money is allocated where it is most needed. The EU’s current financial reforms did not change the basic functioning of the financial sector. No particular attention has been paid to the interests of developing countries. The Euro and the new bank crisis in 2011 show how insufficient the reforms so far have been to achieve even basic financial stability.

☐ Slow and difficult EU decision making resulting in weak proposals
The EU has been implementing its weak financial reforms at a very slow pace. Major legislation to reform the banks and the financial markets is only being proposed in the second half of 2011, three years after the crisis broke out in the EU. The slow and difficult decision making of the EU reflects how national governments, regulators, and even supervisors continue to consider it their task to protect the competitiveness of the financial industries in their respective countries. In the same ways as before the financial crisis, the financial industry has successfully used the complexity and the argument of competitiveness to forcefully lobby against new rules that would curtail its model of maximizing profits.

80 For the report of the Special Committee on the Economic, Financial and Social Crisis, see: http://www.europarl.europa.eu/en/headlines/content/20110324STO16431/html/Pervenche-Ber%C3%A8s-To-get-out-of-this-crisis-we-need-to-work-together
Continued political protection of financial sector interests is now conflicting with the governments’ task to protect the public interest against financial instability, speculation and budget cuts which undermine basic public services. The EU rules still allow trillions of dollars to circulate in speculative financial markets while governments and many citizens are short of money to fulfil basic needs: a serious misallocation of resources, to say the least.

☐ **Missing reforms**

Proposals for restructuring the functioning of the financial sector that are missing from the current and upcoming EU legislation are changes such as:

- splitting retail banking from investment banking,
- a ban on socially or economically useless financial products,
- strong interventions in financial markets that are dysfunctional,
- testing of each financial product before it can used, and
- a total prohibition of tax havens.

As opposed to a financial sector that increases the gap between the rich and the poor, civil society wants to reverse the current model of the financial sector towards integrating sustainability and the interests of developing countries.

Exploring alternatives includes promoting a diversity of banks to include ethical banks, cooperative banks, mutual societies or even nationalised democratically controlled green banks where needed. More thinking out of the box could be inspired by the report of France’s Commission on the Measurement of Economic Performance and Social Progress, led by Professor Stiglitz: it may be of use to design a financial system that serves especially the poor, helps reverse climate change, promotes food security and sustainable energy.

☐ **Citizens discontent**

More EU citizens and civil society organisations need to become active in all kind of ways to claim another financial sector that benefits both all citizens in the EU and the developing countries. Campaigns against food speculation and the European movements that became visible following the ‘occupy Wallstreet’ actions in October 2011, show the discontent with the restructuring of the financial sector. This report hopefully will contribute to practical as well as more fundamental proposals on how to reverse the current crisis-ridden global financial system.
ANNEX: Glossary

**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)** consist 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 its debt.

**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:

- **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.
The Missing Dimension
How European Financial Reforms Ignore Developing Countries and Sustainability

This report critically analyses a selection of major reforms of the financial sector as agreed or still being discussed at the level of the European Union (EU). The specific aim of this report is to identify where developing country interests as well as social and environmental sustainability are at stake, what concerns need to be raised and what concrete remedies could prevent (potential) negative consequences. The conclusions of this report point out that the interests of developing countries and the perspective of social and environmental sustainability are currently a missing dimension in the EU’s financial reforms.