COMMENTS FOR THE CONSULTATION BY THE EC, DG INTERNAL MARKET, ON FINANCIAL MARKET SUPERVISION

Contribution by BankTrack

BankTrack is a global network of 28 civil society organisations monitoring the activities and investments of globally operating commercial banks. BankTrack's activities and statements, including about the financial crisis and the need for reregulation of the financial sector can be found at : http://www.banktrack.org

Civil society organisations and their umbrella organizations like BankTrack consider that they are interested parties[1] and stakeholders in this consultation process because the impact of new supervisory mechanisms will not only have impacts on financial stability and the economy but also on much more aspects of societies in which financial operators and financial markets function.

It is very regrettable that the EU has so far not included a broad and independent range of experts and stakeholders te get advice on how to address the financial crisis. The de Larosiere High Level Group was composed of people who still have or used to have strong links and interests with the financial sector. Many of them have supported for years the policies that lead to this crisis and should not be considered appropriate in advising the EU how to solve the crisis. The information in the Commission's expert register that these 8 members of the Larosiere group are academics is highly misleading. See <http://ec.europa.eu/transparency/regexpert/detail.cfm?ref=2262&l=all>

In this submission, we would like to explain how supervisors should play a role in safeguarding the public function of the financial industry and especially banks, as was as the role the financial system can play to achieve (environmental) sustainability and (social) equity in societies.

We are aware that the activities of supervisors are based on the mandate received from financial regulations and therefore this document does not include all our criticisms we have on the regulations proposed by the European Commission and de Larosiere Report (see Annex). However, we are very much aware that Central Banks and supervisors are advisors to regulators and therefore should in their advice take account of trends in society such as banks being challenged about the impact of bank project lending on the environment and voluntary initiatives by banks to take the environmental impact into account (e.g Equator Principles). Central Banks and supervisors are also involved setting international standards and participate in international fora dealing with financial stability. Here and there in the document below, there might be elements of where supervisors can propose improved regulation.

[1] The consultation is called "consultation of interested parties"

The comments are in the following order:

- Reformulating objectives of supervisors
- Supervising beyond financial stability
- Accountability, democracy and transparency
- Global supervisory cooperation
- Coordination
- Budget
- Other issues

REFORMULATING OBJECTIVES OF SUPERVISORS

The EC's objective of a new supervisory structure is to "meet the challenge of complex international financial markets" (EC document of 4 March, Annex I , p. 2 (a)) .

To our opinion, supervision should include meeting the challenges of the financial sector's role in societies, and especially in making societies equitable and environmentally sustainable. Promoting and protecting the public interest of the financial system should be the primary objective of supervisors. This for instance includes ensuring that marginal, poor and vulnerable clients are being served and that financial services do not focus too much on serving the rich.

Overall, the proposals on supervisory structures contained in the documents are based on an approach whereby the supervisors constantly try to catch up with the innovations and expansion of the financial sector itself.

A better approach would be one whereby supervisors aim much more pro-actively at preventing financial instability based on the precautionary principle. This could be done for instance as follows:

- Implement a European-wide approval process of every new financial product brought on the market, especially speculative products. One important criterion for whether or not to approve a new financial product must be to ensure that it the product does no harm to the public interest and the environment. This "do not harm principle" (directly and indirectly) should also include ensuring that the new no financial product will result in financial instability or become a "toxic" product. The innovator should demonstrate conclusively that a new product will do no harm.
- Where new financial products that have social objectives (e.g. cheap housing loans) could lead to less income for the financial sector (whose focus in developing innovations has been on rich and speculating clients), supervisors should ensure that such financial products do not increase risk taking (e.g. securitisation and credit derivatives) to increase profitability. Undue risks to increase profitability of low profit financial products leads to financial instability, as the sub-prime mortgage crisis has

shown. Supervisors should indicate to politicians where commercial banking is impeding social and environmental objectives of governments, and where other financing instruments would be welcome. In general, supervisors should ensure that no unrealistic expectations are made about the profitability of new financial products, and the financial sector activities in general.

- Prohibition of too complex and risky financial products, or financial products that are too costly to supervise.

- The objective of supervisors should be to aim at avoiding any supervisory failures, contrary to what de Larosiere Report says (para 149 "it is inevitable that there will be failures form time to time, and the arrangements for supervision have to be seen with this in mind"), i.e. supervisors need to implement the precautionary principle and the speculator pays principle. This also means that supervisors should advise and be involved in international standard setting which aims to avoid financial instability, crisis in societies and moral hazard. Regulations in the 1950s and 1960s were able to avoid financial crises which only occurred in the last three decades (see ANNEX).

- Impose limits on the size and role of financial corporations. Supervisors should prevent a bank, insurance company or another financial operator to become too big to fail, too interconnected to fail, too big to be saved or to cause too much instability so that it threatens financial systems and societies. De Larosiere report is wrong in stating that "it is unlikely that large financial institution will be broken up into component parts" (para. 234) since supervisors should have the power too break up financial "giants" if they are "too big to manage" and are a threat financial instability. In addition, some financial conglomerates are already introducing measures to make clear separation between their banking and insurance companies (e.g. ING). Supervisors should work more with European and national competition authorities whose mandate should also include to intervene when banks become too big to fail and too big to be saved.

- Strict criteria should be fulfilled by CEOs, board members, management, and the supervisory bodies of financial companies in order to ensure integrity, financial stability, environmental and social sustainability, and servicing the public interest of the financial sector. Supervisors should closely supervise voluntary and legal obligations, and the remuneration structure to that extent (see also next section).

- Assess, and ensure that all financial operators have balanced dialogues with stakeholder, i.e. that stakeholder dialogues are not limited to shareholders and investors. All stakeholders (workers, consumers, civil society organisations and other stakeholders) should be adequately consulted and getting the necessary information through transparency measures enforced by supervisors.

- Supervisors should not allow off shore banking and off balance sheets, and help develop rules and supervisory structures to that extend. The objective should be to avoid any risk of opacity, complexity and lack of transparency to would prevent supervisors from assessing potential and direct financial risks and other societal risks.

The proposals in de Larosiere Report have given in to political sensitivities whereby the national interest are being equated by protecting the national financial industry and the financial center of a country against foreign competition. However, the approach on which supervision should start is that financial services should be at the service of a sustainable society and that growth or preservation of one's national financial industry does not necessarily serve the public interest of a country. It is not a supervisor role to protect the growth of the financial sector of a country or of the EU. In the past, political and economic pressure to ensure the 'competitiveness' of the financial industry has resulted in supervisors relaxing strict enforcement of regulations which were already being weakened by the same political interest to ensure that regulations would not prevent the growth of a country's financial industry.

Therefore, for all financial operators, not only banks or insurance companies, which operate across borders, supervisory structures must be established on the international level as well as the EU level,to ensure all supervisors are subject to the principle of "do no harm" to other countries where the same cross border financial operator are active, through due mechanisms allow to integrate countries' due public interests and specificities.

The refusal of the UK (whose light touch approach to regulation has undermined regulation and supervision processes at EU level and made Europe more vulnerable to financial crises) to establish European supervisory structures whereby not the home supervisor takes the final decision, and France's refusal about European wide insurance company supervision because capital reserve requirements that would harm French insurance companies should therefore be questioned.

Solutions to overcome differences between home and host countries should mainly serve the public interest at national, EU level and international level, and not only be taken from the perspective of the growth or protection of the financial industry (that has been lobbying heavily at EU and international level against strong financial regulation and supervision although financial conglomerates are interested in cross border supervision to avoid complex national legislation.)

SUPERVISING BEYOND FINANCIAL STABILITY

The proposals contained in the European documents that are subject to this consultation have the objective of "consistent set of supervisory rules" with no national derogation or additions, "a harmonized core set of standards is defined and applied throughout the member states" (EC document, Annex I), "a high level minimum standard" for all supervisors in the EU (de Larosiere Report para. 41)

At least such supervisory rules should include the obligation that supervisors make assessments of the risks of the financial system, financial markets and particular financial operators (micro-prudential supervision and macro prudential supervision) to the environment, social development (e.g. gap between rich and poor) and societies as a whole. In other words, the supervision of the financial sector should not only aim at contributing to sustainable economic growth (de Larosiere Report para. 151) but also to the development of sustainable, low carbon economies and equitable development in all societies in all countries.

In order to facilitate supervision to that extend, banks and financial institutions and their directors should be legally responsible for social, environmental and human rights impacts of the projects and companies that they finance and support, and the financial products that they sell. They must have a legal duty of care not to commit or be complicit in human rights and environmental abuses. For instance, they should not sell speculative products in food commodities that cause food prices to rise and hunger to increase, so that the right to food is undermined. This will balance the legal duty banks currently have to maximise profits for shareholders. Supervisors should be responsible for enforcing this legal duty. Other stakeholders can also play a role in promoting the public interest, including social and environmental operations of the financial industry, if sufficient transparency is guaranteed (see also next section).

ACCOUNTABILITY, TRANSPARENCY AND DEMOCRACY:

- Supervisors so far have very little communication channels with stakeholders such as consumers, employees and unions, civil society and non governmental organizations (NGOs) e.g. those dealing with anti-poverty and social justice, environmental protection and sustainable development, and human rights. Supervisors should provide appropriate channels for communication with civil society organizations so that their views can be heard by supervisors. This should allow discussions for instance on gaps in supervision or on needed changes in the financial sector regulations (on which supervisors give advice) to guarantee the public interest.

- Cancel privileged access: The close contacts behind closed doors between supervisors, regulators and Central Banks on the one hand and the financial industry on the other hand has lead to damaging 'regulatory capture' in the past. Banks and financial institutions have enormous (lobby) power and had great influence over national, EU and international financial policies. The granting to the financial industry of privileged access to decision making processes should be cancelled at national, European and international level. Advisory groups that are controlled by representatives of the financial sector should be abandoned.

- The process leading to the creation of a European system of financial supervision (part IV of Larosiere Report) should include sufficient stakeholder consultations that are not confined to a few non-financial sector stakeholders and provide the means for non-financial stakeholders to meaningful participate in the dialogues, consultations, etc. (such financial support should not be confined to small investors only). Such non-financial sector stakeholders include unions, employees of the financial sector, consumers, civil society organisations from all countries where European financial actors are operating.

- Where supervisors have made mistakes, there must be due democratic and political procedures to make supervisors accountable for their mistakes and remove supervisors who are failing in their duty. The principle in de Larosiere Report (para. 187) that supervisory work must be independent from political authorities but should be fully accountable needs further elaboration. Supervisors' and central banks' independence of political procedures needs to be reviewed as the weaknesses have been apparent in the last decade, and should be subject to criteria such as the decision-making of financial regulation that supervisors have to enforce, has to be democratic (see footnote 10 of Larosiere Report para. 187).

- Any dialogues between supervisors and the financial industry regarding solutions to the financial crisis, supervisory structures and regulation in general, must be conducted in a transparent and democratic fashion and secrecy for pure supervisory reasons should be reduced to a minimum.

Supervisors and financial operators should provide much more transparency about their activities, including lending, so as to increase possibilities for better accountability and stakeholder discussions. Guaranteeing as much transparency as possible (against the argument that most requires confidentiality to protect company secrets) should be a tasks of supervisors. In order to facilitate the work of supervisors and stakeholders, multinational corporations should be obliged to report on all their activities and transactions on a country by country basis (both third-party and intra-group), labour costs and number of employees, finance costs (third-party and intra-group), profits before tax, provisions for tax and tax actually paid, and tangible asset investment, without exception for any jurisdiction. In order to improve accounting and supervision, supervisors should increase their capacity of surveillance of accounts of financial operators.

Supervisors should promote that the International Accounting Standards Board (IASB), where such accounting standards are adopted, be reformed from a private entity into a specialist Commission of the United Nations Economic and Social Committee, with appropriate input from stakeholders from civil society and business. There are great concerns about company auditing being not a function of the state, but a commercial activity commissioned by each company for itself. That practice introduces an unacceptable conflict of interests, as illustrated in auditing failures over the last decade.

GLOBAL SUPERVISORY COOPERATION

- The supervision of European banks and European insurance companies or equity traders, in whatever form, should also include at least the consultation if not the active involvement, of supervisors or central banks of those countries **beyond the EU** where these European financial companies have an important market share, for instance from 10% onwards. This goes beyond the recommendation of the de Larosiere report that especially the financial "giants" should have supervisory structures at international level. In some developing countries, the presence of foreign banks or other financial operators take such an important part of the financial system that decisions taken by foreign supervisors might have major impacts on the financial and monetary systems of these countries. Also, the activities of these foreign financial operators such as foreign banks might have a negative impact (e.g. foreign banks withdraw saving money from host country to home country). As long as the cooperation between supervisors especially between those from Western home countries and those of developing countries is not sufficient, host country supervisors should have the precendence over home supervisors to protect the financial stability, public interest, customers and investors in the host country. For the same reason, host country supervisors should also be able to have decision-making over branches of banks.

- All supervisors should have the duty to avoid spill-over problems into other countries of financial operators under their supervision, and should have a duty of doing no harm to host countries where financial operators under their supervision have commercial activities. The supervision of financial cross sector conglomerates is an urgent matter, especially of no splitting of those conglomerates is being envisaged. The principles established above should also apply for supervision at international level.

- The FSAP of the IMF needs to be improved and incorporate the many principles, duties and criteria of supervision (and regulation) as described above.

- Supervisors should not only reduce international risk and volatility by imposing restrictions on cross-border lending and cross-border bank ownership, but also on lending in any country in a foreign currency to avoid that problems are created as now in Hungary and Romania where as many as 55 per cent of households hold foreign exchange household loans.

- Financial supervisors need to promote competition policy, both at national, EU and international level, to ensure that financial conglomerates that are 'too big to fail' and too big to manage or supervise, are being reduced in size.

COORDINATION

- After the G20 summit decisions, supervision of banks and non-bank entities such as hedge funds should be organized at international level in a manner that makes supervision really meaningful and avoids duplication of EU efforts (but rather the EU supervisory structures should underpin and strengthen international supervision). Supervisors should encourage very strict regulation of Hedge Funds and prohibit activities that cause major damage to society, such as speculating in food commodities and foreign currencies of developing countries.

- There should be an immediate response of direct cooperation in supervision of financial conglomerates that combine retail banking, investment banking, insurance and securities trading. Some coordination is taking place at national level but the European supervisory structure is still split in supervision of banks and insurance, and security trading. The long term process proposed by de Larosiere report does not deal with current problems of instability and vulnerability and must be immediately complemented by a set of proposals that guarantees increased supervision at EU level of cross-sectoral financial conglomerates to ensure stability in the near term.

- Supervisors should have the task to coordinate or at least have an overview, with powers to intervene to protect the public interest, of different policies towards the financial sector. For instance, supervisors have currently very little information and assessments of the impact of trade agreements (GATS agreement in the WTO, Free trade agreements including the EPA agreement between CARIFORUM and the EU) in which financial services are liberalized, regulation is restricted (see Article XVI of the GATS, and the GATS "Understanding on Commitments in Financial Services") and capital controls are severely restricted. The European Commission continues to push for liberalization and deregulation of financial services in developing countries through free trade and investment agreements, which runs counter to what is happening at the EU level, and is not coherent with the fact that international and regional financial regulation and supervision is not yet in place.

BUDGET

(see de Larosiere Report recommendation 22, p. 55)

Given the new many regulations that are being proposed by the G-20 on much more entities, including rating agencies, and in different ways e.g. more judgment rather than relying solely on internal risk models, sufficient resources must be made available to hire the required expansion of highly skilled staff. Is there political will to provide enough for highly qualified staff at supervisory bodies? Will the new commitments to tackle tax evasion and avoidance provide the necessary sufficient resources? Will fraud investigations be strengthened (especially in the UK because of the behaviour of the City of London, but not only there)? Fraud is investigated by national police forces, and the EU should give a clear signal to strengthen them. This will require the fullest communication and cooperation between international supervisors and the anti-fraud police in all countries.

When supervisors are also authorized to control behaviour that can lead to sanctions, they will need sufficient budget to build up cases and defend themselves against legal threats by financial companies against their charges.

OTHER ISSUES AND COMMMENTS

- Priority should be given to improve transparency, accountability and oversight instead of improving the business environment. The proposal to reduce accounting burdens on micro-enterprises (page 10) runs completely counter to the need for better accounting

- The proposals on how to transform the current bonus system should be much clearer and concrete, and should support the public function and the principle of no social and environmental harm by financial commercial operations and their managers.

- The proposals for improved financial regulation and supervision still rely on the same neo-liberal policies that caused the crisis. Since the IMF has supported such policies, the IMG should not play a central role in international financial supervision but more much importance should be given on the role the UN could play and is already playing.

- Economic stimulus packages should support the ecological transformation of the economy and create socially and ecologically sustainable jobs in the EU but also elsewhere in the world, and supervision is needed to ensure this happens. Supervisors should promote the introduction of global financial transaction taxes and corporate taxes to fund economic stimulus packages which aim at the ecological conversion of the economy – investment in public transport, in public services, in promoting sustainable agriculture and localized food systems, in sustainable energy production (this excludes nuclear energy or the promotion of agrofuels for transport), and to other climate change relevant investments. In the Global South, such funds must in particular be invested into the agricultural sector, promoting localized food systems, based on organic food production.

ANNEX

Para 149, 'it is inevitable that there will be [banking] failures from time to time' cannot be supported by the following evidence. The economists Kenneth Rogoff (a Nobel Prize winner) and Carmen Reinhart have examined 18 bank-centred financial crises from the post-Second World War period, /and the earliest they found was in 1974 ; see <www.economics.harvard.edu/files/faculty/51_Is_The_US_Subprime_Crisis_So_Different.pdf>, p.3).

The 1950s and 1960s must have been the only period in the history of capitalism when there were no banking crises, so there must be things we can learn from the policies of that time. It seems that the following were some of the aspects and policies that kept banking and finance under control:

- fixed exchange rates;
- currency exchange controls in all countries (first removed unilaterally as late as 1979, in the UK);
- almost no lending between banks - they had to rely on customers' deposits to finance their loans;
- the bankers' primary obligation was to their depositors (whose money they have to keep safe), not their shareholders (who want a profit out of the business);
- a strict separation between different forms of banking; this varied from country to country, but the classical one was that in the US between investment (or 'casino') banks and commercial (or 'utility') banks under the Glass-Steagall Act, which was repealed in 1999;
- no financial derivatives (even commodity futures were much simpler, more limited in scope and better regulated than they later became)
- strict rules on bank lending, for example in the availability and amounts of loans for house purchases, and strict limits on consumer borrowing.

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