Changes in European Banking Regulation

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Conservative and liberal forces are calling for "new forms of democracy" to end the hold of banks and markets over governments and politicians. Currently, the debts of banks exceed those of European Union Member States by nearly a factor of three. The 2008 financial crisis, European Union (EU) bailouts paid to Ireland, Greece and Portugal, pending bailouts for Cyprus and Spain, and the recent uptick in European bank scandals are leading to more regulation of international financial markets and to banking activity within the Member States. Germany and France are spearheading the efforts to adopt a financial transaction tax, a tax to which eleven European Union Member States have already agreed in principle. German Chancellor Merkel has repeatedly advocated the regulation of international financial markets, and measures of European Union legislation and German laws have been adopted, while others continue to be debated.

Parallel to this development are the discussion revolving around survival of the Euro and the contentious issue of potential joint and several liability among Euro countries, necessarily extending to joint and several liability for bank debts. Moody's downgraded Germany's credit rating from stable to negative partly because of Germany's collaboration in target rates through the central bank system which handles international payments among European banks. However, the German government refuses to publicly discuss this issue. **The tight connection between the financial sector and national economies is generally seen as at the crux of the problem, a view shared by an informed society.**

Such societal influences unseen just one year ago now abound. The Zurich Money Museum's exhibition *The Play with Luck* (*Das Spiel mit dem Glueck*) is advertised with the statement "The comparison between an investment banker and casino gambler is educational - with several parallels." The *Frankfurter Allgemeine Zeitung* published an article titled *Decay in the financial district*, with a subtitle affirming that bankers bet against customers, launder money and manipulate interest rates. *Die Zeit*, a weekly newspaper, published an informative piece September 13, 2012 about Obama and Wall Street, titled *Ingratitude is the banks' thank you*. The article traces the U.S. bank and insurance bailout, the lack of prosecution for the mishandling of mortgages, and the continued power of the same Wall Street bankers. Most significantly, it addressed the abolition of the 1929 Glass-Steagall Act with reference to Timothy Geithner and Robert Rubin. The **separation of investment and merchant banking** is the new topic.

EU Financial Transaction Tax

France, Germany, Belgium, Austria, Portugal, Slovenia, Greece, Italy, Spain, Slovakia, and Estonia have agreed to establish a financial transaction tax. Some Member States have not so agreed out of fear to lose out on trade and investments. The United Kingdom did not participate because of its desire to protect London as financial center and because it already imposes a so-called stamp tax for certain financial products. Sweden and the Netherlands are vehemently opposed because they believe the tax will negatively affect competitiveness. The tax is slated for collection in 2014 and will amount to 0,1% for trades of shares and 0,01% for trades of derivatives.[1]

[1] European Commission Proposals for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC

Supporters of the financial transaction tax claim the tax would have a stabilizing effect on financial markets and discourage short-term speculative investments without hindering long-term investments. The model for the tax is the U.K. "stamp tax" which has been collected since 1694. British Economist John Maynard Keynes whose ideas profoundly impacted macroeconomics and influenced public policy, is cited in 1936 as saying that a financial transaction tax would calm the market and lead to more long-term profit orientation.[2]

EU Commission President Jose Barroso introduced the proposal for the tax in 2007 and it has been discussed ever since. Greek Socialist and EU Parliament Vice President Annie Podimata declared: "The EU is the biggest worldwide financial market, therefore, it is up to us to take the first step. We cannot be held hostage by a hand full of Member States".[3]

EU Ban on uncovered short sales

As of November 1, 2012 uncovered short sales of shares, bonds and credit default swaps are banned in the EU. Regular short sales are allowed, but anything beyond a threshold volume must be reported to a supervisory authority. JP Morgan estimates that the new regulation will have little effect, as by now nearly all short sales are covered transactions. It is expected that the risks and defaults involving uncovered short sales will be avoided and the regulators intend to prevent speculation with credit default swaps against member states.[4]

The European Systemic Risk Board and German Act to strengthen financial stability

Germany's legislature currently is debating a bill entitled *Act for the Strengthening of Financial Stability*. Its thrust is supervision of financial markets and the financial industry so as to avoid systemic financial crises and their negative consequences, such as depressed economic growth and loss of jobs. This bill follows last year's establishment of the European Systemic Risk Board (ESRB), comprised of 65 members, including representatives from the European Central Bank (ECB), national central banks and the EU Commissioner for Economy and Currency.[5] The board is authorized to issue warnings and recommendations if it sees serious risks for financial stability in Europe.

Investment Banking vs. Merchant Banking

Basel III, the global regulatory standard on bank capital adequacy, stress testing and market liquidity, goes into effect in 2019 and will force banks to increase capital holdings and reduce costs in order to make up for declining profitability.[6] It is predicted that investment banking which carries the most risks will be less profitable. An EU group of experts, under the tutelage of International Monetary Fund (IMF) Governor Erkki Liikanen, has proposed to separate merchant banking from investment banking in order to allow for the separate liquidation of the investment sector in emergencies and to protect tax payers from possible liability due to bankers' faulty speculations. The President of Bafin (*Bundesanstalt für Finanzdienstleistungsaufsicht*-German financial supervisory board) has publicly questioned the viability of the "universal bank" relative to the concept of the "separate bank" (*Trennbank*).

The consulting firm Roland Berger predicts during the next five years 75,000 jobs of the 650,000 bank jobs currently in Germany will be eliminated. Deutsche Bank has announced a cut-back of 2,000 jobs and Swiss bank UBS announced a cut-back of 10,000 jobs, primarily in investment

[2] Keynes, J.M., The General Theory of Employment, Interest and Money, New York, 1935; Spiegel-Online International, November 1, 2012, What would a European Tobin Tax really mean?
[3] European Parliament Information Office Germany, available at www.europarl.de, Finanztransaktionssteuer, May 23, 2012
[4] Regulation (EU) no 236/2012 of the European Parliament and Council of 14 March 2012 on short selling and certain aspects of credit default swaps
[5] Regulation (EU) no 1092/2010 of the European Parliament and the Council of 24 November 2010 on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board
[6] EU Directive CRD IV (Capital Requirements Directive)

banking. At the same time it is understood that political and public pressure is necessary to prevent a rebirth or continuation of the same old habits of self-dealing. It is expected that U.S. banks, such as Goldman Sachs and JP Morgan will reach for a bigger share of the global investment market. The power of Wall Street lobbyists is well-known and skepticism about U.S. intentions prevails.

<u>Germany's TARGET2 Balances</u>

TARGET2 is the name of the payment system for international payments among banks in the Euro-zone.[7] It is a balance sheet system.[8] It works like this: The Target system allows a German seller's bank in a sale to a Greek buyer to obtain a credit against the Target system which becomes at the same time a debt of the Target system. The Target system then credits the Greek central bank with same amount and ends up holding a debt claim. Basically it works like paying a friend's debt. The only difference is that repayment never takes place and the German Central Bank lacks the discretion to allow or disallow a transaction.

Until August 2007 the payments remained more or less balanced. Since then, Greece, Ireland, Portugal, Spain and Cyprus have accumulated large deficits, leaving Germany, France, and the Netherlands holding huge debt claims which never come due and are uncollectable.

Highly regarded economist and IFO-chief Prof. Hans-Werner Sinn analyzed German Target balances and has long warned that the target system was an „ECB stealth bail out" and that „the German Target claims represented an expoure risk should the euro break up and that this exposure would equal the total clams, and not just a share of Target exposure to the crisis countries." [9] **The IFO Institute** is the **Institute for Economic Research** at the University of Munich and well-known for publishing its monthly Business Climate Index. Sinn states that the volume of the target credits given to the European crisis countries is nearly five times as large as the EU purchases of debt papers and more than twice as large as the official EU bailouts. Sinn further states that should the Euro-zone fall apart, Germany would have target claims against a non-existing system with a loss of 727 billion Euros. If just the crisis countries leave the Euro-zone, Germany's loss would be 416 billion Euros. His conclusion is that Germany has exposed itself to be blackmailed into approving unending bailouts. He compares the situation to giving someone a Gold Card and then a Platinum Card to allow more purchases. This is scary, indeed.

<u>Conclusion</u>

The EU is in dire straits. Tweaking has not worked. With plans towards an ECB supervisory entity of all European banks the public discussion continues in an effort to find a solution that is workable and acceptable to all Member States. So far it seems that the Member States move farther apart than together.

Low savings interest rates and increased inflation have been the consequence of the ECB flooding the market with billions of Euros. It is understood that there is not and will not be enough money to finance the various national debts and bank debts. Economists talk about "cold expropriation" of tax payers' savings and a pending break-down of the German economy within the next five to ten years. One thing is sure: there will be more banking regulation and investments will be less profitable. Whether new forms of democracy will develop remains to be seen.

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[7] Guideline of the ECB of 26 April 2007 on a Trans-European Automated Real-time Gross Settlement Express Transfer System (TARGET2) (ECB/2007/2)

[8] What are TARGET2 balances? https://www.ecb.europa.eu/ecb-and-you/explainers/tell-me-more/html/target2_balances.en.html

[9] Hans-Werner Sinn, Target Debate, https://www.hanswernersinn.de/en/controversies/TargetDebate