REGULATION OF FINANCIAL MARKETS

Introductory ideas about the current problems

It has become increasingly clear particularly in this century that through the destructive impacts of financial markets, economic crises are often amplified to proportions which set the entire system at risk. V. Cerra and S.C. Saxena[1] have shown that failures in real economy brought about by instability and failures in the financial sector have an extremely destructive impact, particularly in the developed industrial countries. Therefore the effectiveness of the economic systems of the Western world has been regarded increasingly questionable in public discussions and implementation of comprehensive reforms is demanded, particularly in the banking sector. Intervention with social and economic policies becomes necessary. The issue of who has the decisive say in the economy and in the society as a whole is often raised – democratically legitimised representatives of the general public or the managers sitting in the boards and councils of banks who seek profits in financial markets with extremely speculative self-interested transactions? Comprehensive regulation of financial markets has become absolutely necessary more than ever since the first signs of the beginning of the financial crisis in 2007, in order to prevent conflicts between self-interests of banks and the common good.

The essence of the demands that have stood out in discussions has been to separate speculative investment banking (above all trading on own account[2] and lending to hedge funds) clearly from classical lending and depositing activities in the so-called universal banks, i.e. banks with a wide range of business activities (ring-fencing). That way it would be possible to stop setting at risk client-based business activities in banks which are faced with bankruptcy due to their risky investment transactions. According to the current experience, such banks are eventually rescued (bailed out) with state funds because of their importance for the economy[3]. Taxpayers eventually bear the burden[4]. The state becomes a victim of extortion. The function of banks as service providers to real economy should be restored in order to avoid such a situation in the future. This assumes the creation of a system which would keep commercial banks separate from investment banks.

The Volcker rule[5] from the U.S.A. is the most radical of these proposals. According to the proposal, banks should not be allowed at all to participate in hedge funds and

[1] Cerra, V./Saxena, S. C., Growth Dynamics: The Myth of Economic Recovery, IMF Working Paper, 07.08.2005.

[2] „Casino within a bank“ like the German *Handelsblatt* calls trading on own account on its front page on 30 January 2013 as it may not take into account the interests of responsible clients.

[3] These banks are referred to as being „essential for the system“ („too big to fail“).

[4] German social democrats refer to it as „capitalism dominated by financial markets“.

[5] It has been named after Paul Volcker, the Chairman of the Board of Governors of the Federal Reserve System in 1979–1987, currently a senator.

private equity funds, to own or finance them, or to trade on their own account[6] at their own risk[7]. The Liikanen Report[8], on the other hand, is favoured more in the European Union. It is dreaded that due to the strict conditions of the Volcker rule the prohibited transactions may be performed in the form of „shadow banking". Therefore the Liikanen Group recommends to major banks[9] to keep their traditional transactions of private and business clients separate from their risky operations performed at their own risk in financial markets[10,11]. Holding companies created according to the OECD model are meant here, with subsidiaries which are legally and financially independent organisations with their own banking licenses and each responsible for one business area. An investment bank which becomes insolvent due to its risky transactions could be liquidated independently of its client-based business area. Credit and deposit transactions and therefore also the funds of bank clients would be protected. Because only such original banking transactions are related to real economy. Such keeping apart would make it possible to connect the risk closely with liability related to only profit-oriented activities in separate business units.

It is quite understandable that such conceptions on keeping activities separate were not approved by the banking communities. Counterarguments are not very convincing, however. Expenses related to organisational structure should not increase much as the main part of the basic business expenses – such as electronic data processing – can be used by all subsidiaries also in the future. However, the business units that would be engaged in investment banking would not be able to rely on the ratings of the customer service units and that would surely increase their

[6] Trading in securities, currencies, precious metals and different kinds of derivatives on own account.

[7] According to this, the activities of banks should be limited to orders received from clients, and banks themselves should not perform risky transactions with only speculative self-interested motives. (Hilger, H. A., Aktueller Begriff: der Glass-Steagall Act und die Bankenregulierung (Nr.05/10): Wissenschaftlicher Dienst des Deutschen Bundestages, 10.10.2012).

[8] Report of the Liikanen Group, an EU Expert Group for the regulation of major credit institutions: [http://ec.europa.eu/internel_market/bank/docs/high-level_expert_group/report_de.pdf]; the report is named after Erkki Liikanen, the chairman of this group, who is the Governor of the Central Bank of Finland and therefore a member of the European Central Bank Governing Council.

[9] The term „major bank" in the Liikanen Report is related to the proportion of trading on own account in the total assets of the bank (starting from 15%) and/or the absolute amount of trading on own account (starting from 100 billion euros). The Liikanen Report recommends to restrict the obligation to keep the two business areas apart and to apply it only to „major banks". Such a restriction cannot be explained by any practical reasons and therefore we may assume the interests of the banking lobby here.

[10] This does not include transactions ordered by business clients in financial markets, such as risk guarantees for actual, serious valid contracts to insure against fluctuations of prices of raw materials and currency exchange rates. The same applies to credit default swaps and certainly also to issuing of corporate shares. (Cf here also: Eesti majanduspoliitilised väitlused, 2-2012, footnote 17).

[11] That would make it possible to control (as expected) the trading on own account.

refinancing costs. The issue of whether introduction of a system that would keep commercial and investment banks apart would set at risk the reputation of participating EU countries as host countries for financial institutions would still concern only separately performed investment transactions. For client-based bank transactions, closeness to real economy is a practical necessity.

Keeping traditional business transactions separate from risky and complex investment transactions is the most important measure for controlling financial markets. This, however, assumes that not only „major banks“ but all banks would be obliged to keep these two fundamentally different areas separate. A bank which is too small from the aspects of business economy to implement such a separation, should avoid performing such risky transactions.

If it is guaranteed that subsidiaries of a group have no access to the main bank when trading on their own account and that credit institutions oriented only to clients do not engage in investment banking activities and are not allowed to refinance them, the issue of whether trading on own account should be generally restricted or even prohibited is of secondary importance. Purely speculative instruments (forwards) should be prohibited in any case. Such transactions with derivates are risky for the system and partly immoral and have no relation to real economy. Such transactions are based on expectations that prices of commodities, such as agricultural products or raw materials, will change in the future, and are objects of speculation. In the past, such interventions of banks in the functioning of the economy have lead to price excesses. These in their turn set at risk the regular supply of the population with food products – particularly in the poorest regions of the world – and manufacturing sectors with intermediate products.

The remaining bank transactions that should be kept separate consist in speculative trading on own account for the purpose of quoting currency exchange rates, securities and other rights. These too are performed on own account and at own risk and are therefore not client-based. Such trading is performed – similar to the current forward transactions – not on stock exchanges but outside controlled markets, in the form of over-the-counter contracts. As such transactions are mostly not sufficiently secured with equity, unsuccessful speculations may easily lead to the insolvency of the performer of the transaction and start a chain reaction due to interdependencies in national economy. Therefore it is so important to allow performance of the transactions described above in principle only with the permission of a higher level authority[12] and under the control of such an authority.

According to the requirements of the European Parliament, banks should be obliged – and this concerns internationally operating major banks of the Western world – to present in their balance sheet the profits earned from operations in different

[12] Analogously with the Dodd-Frank Act in the U.S.A., the European Market Infrastructure Regulation (EMIR) provides that OTC derivatives will have to be secured, in principle, and agreed on between central counterparties (CCP) and registered in a central register of transactions.

countries and the taxes paid on these profits. Such disclosure would make it considerably more difficult to take their business to tax oases and would help to fight with aggressive tax manipulations.

The principle that economic subjects who perform risky transactions when seeking high profits and bonuses should bear also full responsibility for them should be established and remain in effect in market economy. Risk, responsibility and consequently also liability are inseparable concepts. The situation where banks may be sure of state aid, i.e. eventually assistance of taxpayers, due to their importance for the system should not exist. This will make it tempting to take excessive risks (moral hazard), which makes the whole system more vulnerable and more prone to crises. Losses should not be socialised while keeping the privatisation of profits and outrageously high salaries and bonuses of managers. The losses that cannot be set off in some other way have to be born by the responsible management and owners of banks. This specifically means the following: in the case of insolvency, responsible managers should repay to the company at least partly their salaries earned during a certain period (e.g. from the last five to ten years) to cover the loss, and shareholders should give up their shares[13] in exchange for claims or creditors (debt-equity-swaps, bail-in).

The approach to the payment of bonuses which were originally paid for particularly good achievements should be different. As success or failure becomes evident only several years later, bonuses should not be paid out in cash immediately. Bonuses would be first paid out in the form of bonds – to a certain extent, as surety bonds. These bonds can be cashed after a term of five to ten years, provided that the bank has not become insolvent during that period[14]. The collective liability of bonus recipients could have also an additional effect – each of them would be more aware of possible problems and would take into account the risks related to their activities and would also observe more critically the activities of their colleagues. Such a rule would consequently have a disciplinary effect.

If the debts of a bank exceed its equity in some cases – including debt-equity-swaps – also creditors could be involved in bearing losses through reducing or giving up their claims. That would considerably increase the refinancing costs of the banks which are in difficulties anyway already. Therefore in such cases it would be more right to choose the solution of converting the claims of creditors into obligatory bonds, i.e. to apply the method of surety bonds with potential corresponding increasing of the equity.

In September 2012, Heads of State or Government of the euro area decided to use the European Stability Mechanism (ESM), financed by the countries of the euro

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[13] And also bank managers their shares and stock options received earlier as performance bonuses.

[14] Also disbursement of bonuses could be contingent on that – following the example of Union de Banques Suisses (UBS) – to avoid the decrease of equity quota below a certain limit (in the above-mentioned case below 7%).

area, directly for making aid payments to banks in trouble. This clearly violates the principle that no public funds but only private funds should be used for rescuing business units. In order to prevent the misuse of tax funds for rescuing banks in future crisis situations, a restructuring fund owned by banks should be created on the basis of European law[15] for the provision of financial assistance only if all mandatory conditions have been fulfilled. The vicious circle which has appeared due to the close interconnections of the financial sector with national debt has to be broken once and for all. In that sense, the above-mentioned fund can only be financed with funds from the banking sector itself. Also a liquidation fund can be integrated in that rescue fund to cover unsecured losses of insolvent banks, if necessary. Administration should be assigned to an European financial stabilisation institution independent of the European Central Bank.

In order to guarantee alleviation of potential losses already in advance, existence of sufficient equity should be ensured. This was the subject of the Basel Commission already in 1988. However, in the decisions adopted (Basel I), varying risks of certain assets and liquidity aspects were insufficiently taken into account for the determination the capital requirements. Subsequent decision packages of Basel II and Basel III will have to fill these gaps. Basel II provides creation of equity backings of different sizes for risky assets (such as credits issued according to the solvency/rating of the debtor)[16]. Basel III goes even further, introducing two more precautionary indicators of liquidity: the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). According to both indicators, banks have to retain sufficiently high liquidity in addition to the mandatory equity. This specifically means that the liquidity level of banks (high-liquidity assets and assured refinancing opportunities) should be higher than necessary (for expected liquidity outflows and the necessary stable refinancing).

The basic idea of these preconditions is correct. But looking at their possible consequences the matter should be considered more thoroughly. The indicators described will probably induce banks to issue short-term loans or to use liquid resources for buying reliable securities instead of issuing long-term loans. It would lead to a situation where businesses – particularly during periods of crisis – would have more difficulties in financing their long-term loans. The new balance sheet rules can procyclically strengthen this effect even more. Because if banks present their assets in the balance sheet according to actual market values, it increases the equity at the times of active market but reduces it during crisis. It is very questionable whether and when the European Systemic Risk Board (ESRB)

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[15] According to the model of the German Bank Restructuring Act of 2010. Bearing in mind the currently still extraordinarily varying financial difficulties in different countries of the euro area, establishment of national restructuring funds could be considered instead of a joint fund for banks of the Member States during the transition period until overcoming the European financial crisis. They could later be combined into a common European fund.

[16] Discussions of the new EU Capital Requirements Directive (CRD IV) and the related Regulation (CRR) have still not achieved satisfactory results.

established at the European Central Bank can solve these interconnected problems. Nothing has happened until now in that respect.

According to the current experience, high frequency trading[17] in security markets may have an extremely destabilising effect. Up-to-date data processing technology makes it possible for brokers to execute orders microseconds before other orders with the help of computer-generated algorithms, to combine transactions in the same direction with immediately following transactions in the opposite direction and earn profits that way[18]. In many cases the aim of such actors is just to test the reaction of the security market. Such mixed signals may, however, lead to excessive variations of rates and destroy financial values to the extent of many billions[19] without reflecting actual developments in real economy.

In order to prevent such perverse trading practices in the future, a minimum resting time of stock exchange orders has to be established[20], which is also a recommendation of the Economic and Monetary Affairs Committee of the European Parliament. The resting times should be strictly monitored with computer software. Intermediate solutions have to be found until such regulation mandatory for all is reached in the European Union. Brokers and investment funds who want to perform computer-generated automatic transactions in financial markets should first of all apply for a separate licence to make it possible to monitor strictly their activities[21]. Considerable fines should be imposed on misleading orders placed without the intention of performing actual transactions.

The management of trading institutions and stock exchanges should have the additional obligation to stop trading immediately in the case of extraordinary developments of rates and to identify the causes. Besides – the order-to-trade-ratio should be constantly monitored to detect violations of rules and stop wrong developments in time.

The fees paid to board and council members, salaries of top management and also bonuses paid in the banking sector have grown to such amounts by now that it is difficult to justify them to the general public. Such development sets social cohesion

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[17] Cf here: Lattemann, CH. (*et al*), High Frequency Trading – Costs and Benefits in Securities Trading and its Necessity of Regulations, in: Business & Information Systems Engineering, Vol. 4, 2012, Issue 2, pp. 93 – 108.

[18] Which may be very small in single cases but may add up to large total amounts.

[19] For instance, in U.S. stock markets on 6 May 2010 when the Dow Jones Industrial Average Index lost more than 9% within minutes, which was equivalent to a loss of 1000 points (Flash Crash). It was caused by a wrong order which led to numerous orders sent to the stock exchange from IT systems of high frequency brokers in milliseconds.

[20] The Economic and Monetary Affairs Committee of the European Parliament prefers the minimum resting time of 0.5 seconds for orders. This is surely too short.

[21] Including the algorithms they are using. The respective draft act (Act for the Prevention of Risks and the Abuse of High Frequency Trading – High-Frequency Trading Act) has been discussed in Germany since 30 July 2012. The intention is to subject also transactions performed outside public trading in stock markets (dark pool of liquidity) to this future Act.

at risk. In the formulation of a transparent remuneration system the bonuses have to be related to basic salary rates. If only bonuses were regulated, basic salaries could still be changed in the future to achieve the desired result. Therefore fixed basic salary rates should serve as a basis for the socio-politically justified and transparent regulation.

The easiest solution would be to establish fixed maximum salary rates in financial law[22] that can be recorded as legitimate personnel expenses. The same would then apply to also *uno actu* bonuses if they are limited to the basic salary rate. That way subventioning of the excessive salaries of bankers by taxpayers could be stopped as the taxable profits of banks and therefore also tax revenues of the state are low. Such regulations would not violate the principle of free market economy. Also in the future, the committee with decision-making power in every company could consider whether they should exceed the establish limits if they need to hire highly qualified people to executive posts in the conditions of international competition. For banks such rules would mean that salaries which exceed maximum rates would have to be paid from after-tax profits.

The tax law approach described cannot apply only to the banking sector, considering the basic rights. It has to cover all business enterprises. This, however, would assume harmonisation of the European Union tax legislation, i.e., in essence, the creation of a fiscal union. But there is still a long way to go before EU achieves that and each Member State gives up its own national tax system for the benefit of a common European tax authority. Until then we will have to find an intermediate solution for the creation of socially justified and transparent remuneration systems.

Therefore the maximum salary rate should be fixed first, allowing to pay also higher salaries in exceptional cases and on the basis of definite socially still justified scales. Achievement of outstanding results gives the right to receive bonuses which cannot exceed the basic salary rate. Such a varying form of payment shall not be disbursed immediately, considering precautions for the liability for risks, but should be issued in the form of surety bonds. It would only be fair to set the interest rate of such securities two to three percentage points higher than the interest rate of similar ordinary loans, i.e. higher than that of contingent convertible bonds (CoCo Bonds). All payments to board and council members, also to all high-salaried executives should be disclosed. Disclosure of salary rates may contribute to achievement of moderation.

Fulfilment of the requirements for the regulation of financial markets have to be monitored by higher-level authorities. Financial markets can only be disciplined with strong central supervision. If supervision is assigned to national banking inspectors, they may be insufficiently strict in inspecting domestic banks.

[22] The fact that the rate should be constantly adjusted to economic development, above all the development of prices, may cause difficulties.

The Heads of State or Government of the euro area decided that the European Central Bank should take this task. It is important above all to keep monetary policy and supervision firmly apart both institutionally and on the level of staff to avoid any conflicts of interest. This applies above all bearing in mind the stability of the price level. It is also important to keep a clear division of tasks between performers of supervision on the part of the European Central Bank and on the part of each Member State and to continue close cooperation nevertheless. Cooperation is important also because national central banks have direct contacts with banks and are therefore most familiar with domestic systems and also specific features of local business models and financial transactions. This knowledge makes it easier to compare the strategies implemented. The European banking supervision should, however, have the right to intervene in cooperation with national supervisory authorities in the activities of insolvent banks of countries which are in crisis, in order to encourage their sustainable recapitalisation.

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