www.re-define.org Sony.Kapoor@re-define.org

Key financial system reforms needed and a stock take of current proposals

By Sony Kapoor, Managing Director

Background

The financial system is the 'brain' of modern economies so restoring the broken down system to health is crucial for a quick, robust and lasting recovery. However, there will be no going back to how things were before the crisis. Indeed it would be impossible to restore confidence in a financial system that looks pretty much like yesterday's and foolish to try.

It is imperative that the unavoidable large scale restructuring of the financial system that is taking place be driven by a sound strategy that both helps put finance back up its feet in the short term and implements changes which ensure that finance never falls off its feet the way it has so spectacularly in the past year.

There are those who say that financial system reform and the rejuvenation of credit are separate but they are intimately related with the restoration of confidence being central to both issues. Also, it would be not just careless but downright irresponsible not to institute reform while risking hundreds of billions of euros of tax payer funds and potentially building up future risks in the financial system.

Having a clear vision of what a good healthy financial system should look like is central to both processes 1) restoring credit and rejuvenating moribund financial markets in the short term and 2) regulating and restructuring the financial system so it is stable, fair, equitable and efficient and fully supports the real economy. The thesis that financial markets were best left unregulated and that private financial institutions could largely be trusted to regulate themselves and that market discipline would keep excesses in check has been completely debunked.

Well designed regulation has the potential to both enhance financial safety as well as improve economic performance. It can help restore trust and confidence in the markets and contribute towards kick-starting moribund financial activity. Such regulation can also promote efficiency and equity enhancing innovations and help stimulate the real economy.

We need to move towards a financial system that provides high levels of consumer and investor protection, has larger pools of risk taking capital where risks are borne by those most capable of bearing them, and is robust to shocks and stable. It would also be a diverse financial system where actors are made to bear the costs of their actions, and incentives are aligned with the goal of long term prosperity in the real economy. Such a system would cater to the retail needs of citizens and provide the larger scale more complex support required by the business sector without the need for taxpayer subsidies.

These considerations frame both interventions in the sector as well as the bigger discussion on financial system reform. These are discussed below in a brief and concise way. More details can be found in other Re-Define publications.

Introduction

The ongoing crisis has highlighted several key deficiencies in the current financial system which would need to be addressed if we are to have a financial system which is sustainable and supports prosperity and provides support to the real economy. Some of these are

- There was an excessive focus on the stability of individual institutions and too little focus on the stability of the system as a whole.
    - The issue of systemic stability needs to be at the heart of the regulatory agenda.
- The scope of regulation was too narrow with several institutions such as hedge funds, private equity firms and special investment vehicles falling outside the scope of most bank regulation even as they performed bank like functions. Others such as investment banks and money market funds were too lightly regulated. Markets such as those in derivatives and securitized bonds were also left largely unregulated. In a number of jurisdictions, especially tax havens, the overall regulatory regime ranged from non-existent to unsatisfactory.
    - The scope of regulation needs to be comprehensive and it should extend to all jurisdictions, all institutions, all markets and all instruments.
- The regulatory regime was too procyclical with capital adequacy, loan loss reserve rules, credit ratings, marked to market accounting rules all adding to the already inherently procyclical nature of financial markets and thus amplifying business cycles.
    - The new regulatory regime needs to be explicitly counter cyclical.
- Many financial institutions were allowed to become too big, too complex or too interconnected to fail where their failure would have had catastrophic consequences on financial markets as was highlighted after the collapse of Lehman Brothers. Far from such institutions having to have an extra safety margin of capital and liquidity protections as would have made sense, many had less than for comparable smaller, simpler and less connected institutions partly as a result of arbitrage opportunities and the flexibility provided to them under the Basel II capital accord.
    - The moral hazard problem where these institutions enjoy an implicit subsidy from the possibility of public rescue made matters worse. That is why the new regulatory regime has to find a satisfactory way to deal with such systemically significant institutions either by downsizing them or by introducing extra safety margins which makes them internalize the systemic risks they pose.
- The long bull market and low interest environment led to regulatory complacence where the availability of liquidity across several markets was taken as a given and the 'just in time' liquidity regime where short term borrowing was used increasingly to fund longer term assets contributed in a large way to the vulnerability of the financial system.
    - The new regulatory regime must put the need to maintain adequate and robust liquidity, which has been long ignored in regulation, at the heart of regulation this point forward.

- The fact that there did not exist proper and sufficient legal and financial mechanisms to allow an orderly winding down of financial institutions added significantly to the uncertainty that surrounded the viability of financial institutions. While mechanisms were designed on the go in most major OECD economies, these were ad hoc and inefficient from the perspective of both the tax payer and market confidence.
    - That is why one of the priorities for the new regulatory regime needs to be to formulate a legal and fiscal regime that allows the orderly, flexible and quick winding down or takeover of large, complex and interconnected financial institutions both at a national as well as an international level.
- The lack of proper international supervisory and regulatory oversight stood out in the crisis where regulatory and oversight gaps in the supervision of internationally active financial institutions helped cause the crisis and the lack of proper co-ordination or supranational authority helped prolong it.
    - One of the key requirements for regulatory and supervisory reforms is to introduce mechanisms and institutions that facilitate an effective international supervision program, help co-ordinate regulatory regimes and enable internationally co-ordinated crisis management.
- The pre crisis financial system was characterized by 1) too little capital 2) of insufficient quality and 3) excessive borrowing and embedded leverage. This low quantity and quality of capital eroded the shock absorption capacity of the system and the leverage helped amplify losses and contagion.
    - The new financial regulatory regime needs to have much stricter provisions for the quality and quantity of capital as well as limit total leverage in the system.
- The financial system is rife with mis-aligned incentives and conflicts of interest in the compensation of financial market participants which encourage short termism, excessive risk taking and allow them to ignore due diligence all of which compromise systemic stability and market integrity. This was particularly evident in the case of the origination of securitization, trading by investment banks and the issue of credit ratings.
    - A proper alignment of incentives needs to be at the heart of the new financial regulatory system. At a minimum, the lack of due diligence in the origination and issue of securitized bonds, the conflicts of interests that prevail in credit rating agencies and the risk enhancing bonus schemes that are widespread in the financial sector all need to be addressed urgently.
- The crisis also highlighted the inadequacies of consumer and investor protection in current regulations which were highlighted by the Madoff scandal, the lack of transparency of financial institution exposures and losses and the sale of complex ill suited securities such as certificates to retail customers.
    - The ongoing regulatory reform needs to increase transparency in the system, improve investor protection and institute enhanced consumer safeguards.

What needs to change – A brief discussion of much needed financial system reforms

I. Strengthen regulations, expand their scope and increase international co-operation

- **Comprehensive Regulation:** Regulation should be comprehensive in scope so that there is a presumption to regulate all financial institutions, all financial products and all jurisdictions to fill up the 'regulatory cracks' where risks be hidden from view.

- **Regulate substance, not form:** Regulatory and supervisory coverage should follow the principle of economic substance and function not legal form so if something 'walks like a duck and talks like a duck it should be treated as a duck'.

- **A global regulatory floor:** The EU should focus its financial diplomacy efforts on pushing for a high 'global regulatory floor' that would apply to all jurisdictions including offshore financial centres. This push should be supported by legislation that discriminates against lower regulatory standards by withholding access to the EU market and penalizing financial dealings with such centres with higher capital requirements.

- **Special and differential regulation for LDCs:** Pushing for the global regulatory floor is not incompatible with providing for a special and differential treatment for LDCs and other developing countries with small and immature financial systems which do not pose a systemic risk to international finance and might not have the capacity to implement uniform standards adopted by the OECD and EU.

- **A new 'eagle eye' financial stability regulator:** We need a new 'systemic regulator' which has the capacity to have a 'birds eye view' of the financial system as a whole. This regulator also needs to be empowered to act to take corrective action either by itself or through national level supervisors in the EU to guard against systemic risks which threaten financial stability. This regulator would replace the current Lamfalussy Committees .While a strong empowered regulator is ideal, the idea of a European Systemic Risk Council proposed by the de Larosiere group is a second best solution.

- **A stronger financial stability role for Central Banks:** As the purveyors of monetary policy, overseers of payments systems and lenders of last resort, central banks are in a unique position to identify and stem destabilizing developments in credit markets so the Norges Bank should be empowered to play a much stronger prudential oversight role to help maintain financial stability.

- **A global prudential regulator:** As the current crisis has so starkly highlighted, systemic risk can arise from actions both inside and outside the EU common market so it is critical to have a global financial stability watchdog in order to guard against the recurrence of a financial crisis of this scale. At the very least such a regulator would oversee and co-ordinate the work of regional 'systemic regulators'. It is possible for a significantly reformed IMF or FSF or UN to take up this mantle though there are certain advantages to setting up a completely new institution.

- **New EU institutions for consumer and investor protection and market integrity:** While firms should continue to be supervised at a national level, a close co-ordination of firm level or micro-prudential regulation standards is necessary both to ensure the effectiveness of system level macro regulation but also for the purpose of preventing regulatory arbitrage and providing high and common levels of investor and consumer protection which are central to the smooth functioning of the single market. The consumer protection and investor protection & market integrity roles would ideally be performed by separate EU level institutions working in close co-ordination with each other and the respective national authorities.

- **A special emphasis on large cross border financial institutions:** More than 70% of EU banking assets are managed by 40 large financial institutions with substantial cross border operations. The

supervision of these institutions should be handled by colleges of supervisors overseen by the pan EU regulatory authorities.

- **Equivalence of regulation:** the EU should push for a quid pro quo arrangement of an equivalence of regulation in exchange for offering access to EU markets and investors

II. Improving market infrastructure

- **Develop robust clearing and settlement systems for all financial instruments:** Many new financial instruments including OTC derivatives such as Credit Default Swaps do not have well-developed settlement and clearing systems which increases counterparty risk and compromises both financial stability and market integrity. It is urgent that such systems which provide a centralized and closely supervised mechanism to monitor and settle trades in financial instruments be developed preferably at a pan EU or global level.

- **Increase the standardization of products and proportion of on exchange trades:** While there is a role for customized products, too many of the products traded and sold have been designed with a view to increase profit margins and for regulatory arbitrage. These reduce transparency in the financial system and increase systemic risk. There is a need for regulators to ensure that such products are rolled back and replaced by more standardized products most of which should be traded on closely supervised exchanges.

- **Drive the development of robust support systems:** In addition to these, regulators need to closely supervise legal systems, back office systems, information systems and payment systems and use their statutory powers to ensure that the development of these systems keeps pace with financial market developments. They also need to subject these systems to regular stress tests to ensure that they are robust, efficient and resilient.

- **Introduce centralized information pools:** compiling of relevant financial trading, counterparty and exposure positions in one single comprehensive database should be a medium term objective of regulators

III. Strengthening financial institutions and the financial system

- **Significantly increase the quantity of capital for financial institutions:** The 8% risk weighted capital ratio for banks has proven to be completely insufficient in the event of the ongoing crisis. Other financial institutions such as investment banks and hedge funds, part of the 'shadow banking system' did not even have any minimum capital ratios. This meant that the financial system became increasingly fragile as the loss absorbency capacity and resilience that risk capital provides was eroded. There is an urgent need to increase the capital adequacy of banks and extend the minimum capital requirements to other financial institutions that perform bank like functions and/or could threaten the stability of the financial system. However this increase should be phased in gradually only when the worst of the financial crisis has been dealt with.

  Adequate capitalisation of financial institutions in themselves is still insufficient to ensure that the financial system as a whole has enough capital to guard against systemic risk. That is why the macro prudential (systemic) regulator should assess a systemic risk multiplier over and above the capital deemed adequate by the micro prudential supervisors for individual institutions.

- **Significantly increase the quality of the capital:** Financial innovation, regulatory arbitrage and a strong quest to increase profitability led to a steady deterioration of the quality of capital where equity was replaced by forms of hybrid securities and debt. While equity can absorb losses for solvent institutions these other forms of capital can only absorb losses under insolvency so cannot protect

financial institutions from collapse. That is why when capital adequacy standards are being revised upwards it is imperative that core Tier I capital (equity capital) ratios are increased substantially.

- **Increase capital held against risks other than just credit risk:** Most of the capital that banks and other financial institutions have had to hold has been to guard against credit risk i.e. the risk of non payment of loans and bonds. Even before the crisis there was a growing realization that the existence of financial institutions can materialize from a number of other channels which include market risk, operational risk, liquidity risk and reputation risk amongst others. This crisis has highlighted the role of liquidity risk in precipitating losses. This is why, financial institutions need to be made to hold higher capital not just against credit risk but against these other kinds of risk too.

  Increase capital held against trading books: Old fashioned banking involved holding loans to maturity but changes to the financial system mean that an increasing amount of credit risk being carried by the banks has taken the form of tradable securities such as bonds, credit default swaps, structured securities etc which have become part of what banks call the trading book namely the securities held with an intention of on selling in the financial market. The current capital regime allows financial institutions to hold much less capital for equivalent assets held in the trading book compared to assets held in the banking book which has encouraged regulatory arbitrage so there is a need to increase trading book capital substantially.

- **Mandate minimum funding liquidity requirements:** Financial institutions have become increasingly dependent on short term funding for financing their business. Banks play a critical role in the economy by transforming short term savings into long term assets and hence are susceptible to liquidity shortages. However, statutory liquidity ratios have been abolished by regulators in western financial systems leading to increasing financial fragility. There is now an urgent need to re-introduce stringent prudential liquidity requirements for financial institutions not just banks but other institutions such as investment banks and hedge funds etc which are susceptible to funding liquidity drying up. This liquidity requirement is especially important for financial institutions whose collapse can trigger systemic instability.

- **Legislate for a more conservative approach to liquidity of assets:** As financial markets expanded in scope and depth, the availability of a ready market for assets held by financial institutions has been increasingly taken for granted. As the current crisis which was characterized by a total disappearance of liquidity in many previously heavily traded assets demonstrated, this assumption breaks down in stressed markets. That is why there is an urgent need to account for these 'liquidity black holes' when assumptions on asset market liability are used for determining regulator mandated liquidity and capital structures.

- **Strengthen support for provision of emergency liquidity to funding and assets:** While liquidity problems may be mitigated by higher liquidity buffers and more conservative assumptions they will never be eliminated and the disappearance of liquidity will continue to pose risks of systemic instability. For such eventualities and to guard against systemic risk, there is a need to strengthen and formalize the kind of 'lender of last resort' role played by central banks in the ongoing crisis including offering such support to non banking financial institutions.

  Handling the ongoing crisis has needed not just extensive funding liquidity support by more controversially significant amounts being pitched in to support markets for assets where buyers have disappeared. This may be needed again so there is logic to giving regulators, supported by treasuries, a mandate for such interventions in the future. It might even make sense to ring-fence a publically run fund which should operate on an opportunity cost recovery basis.

IV. Tackling procyclicality in the system

- **Build up buffers in good times:** the financial system as it currently works, reinforces and amplifies financial disturbances. When times are good and asset values are rising, capital seems unnecessary and is reduced and leverage increased which further inflates asset prices. But because of this, most financial institutions arrive into a crisis with little capital. When the crisis hits everyone tries to raise capital at the same time thus cutting of credit and deflating asset prices further. That is why there is an urgent need to mandate a build-up of capital and reserves during booms so these can be run down when the business cycle turns down

- **Changing accounting practices:** current marked to market accounting practices where assets values are tracked on their daily market value increases the procyclicality of the system so an introduction of more considered accounting principles where the value of an asset is linked to the capacity of an institution to hold it would help dampen this cyclicality. For example, if a fund has funding for five years and does not need to liquidate its portfolio in the short term, it should not be made to do so because of daily marked to market pricing.

- **Changing tax laws:** conservative financial institutions which want to keep higher levels of buffers and reserves are penalized under current tax law so there is a need to rewrite laws to enable and perhaps even encourage institutions to hold higher levels of buffers which can help dampen procyclicality

- **Changing risk management systems:** the 'value at risk' risk management systems used in trading are seriously procyclical because they give more weight to recent data and can amplify the cycle. Making VaR systems take a longer time horizon and adding mandatory stress tests will help dampen procyclicality.

V. Increasing financial system transparency

- **Improving disclosure norms:** the default position on financial trades as well as financial institution positions should be full disclosure to regulators with some adjustments made for proprietary information before full disclosure to investors. It was the lack of transparency in the financial system which sapped up confidence in counterparties and too the crisis to the next level.

- **Curbing off balance sheet exposures:** off balance sheet exposures are often used for regulatory arbitrage and also to hide risks away from investors and counterparties. The crisis showed how there is no such thing as a true off balance sheet exposure as they eventually turn up on the balance sheet. In the interest of transparency and for better financial stability and fewer arbitrage opportunities, off balance sheet exposures should be forbidden or at least strictly limited.

- **Tackling complex corporate structures:** large financial institutions on average have far more subsidiaries than corporations of equivalent size often to facilitate tax and regulatory arbitrage. This not only reduces transparency but also makes regulatory oversight much more difficult as seen in the case of AIG and bankruptcy resolution highly complicated as in the case of Lehman brothers. That is why there is a strong case for mandating simpler more transparent corporate structures for banks and financial institutions.

- **Tackling offshore tax havens:** these provide financial actors a home away from the prying eyes of regulators and tax men and support a large chunk of the financial industry. Making these havens adhere to high universal standards of transparency and an equivalence of regulatory regime requirement would promote transparency and stability in finance.

- **Increasing disclosures by hedge funds, private equity firms and SWFs**: these institutions are notoriously secretive and in order to monitor and control systemic risk as well as improve market integrity and investor protection, it is imperative to increase transparency for them

VI. Improving incentive structures in finance

- **Control remuneration packages:** high and asymmetric compensation structures where the downside is relatively small and the potential upside is very high drive high risk taking behaviour of the kind that has landed us in the current crisis. Imposing more symmetry in compensation schemes by increasing personal liabilities, claw back arrangements and limiting the size of bonuses either through punitive taxation or as a fraction of salary would all be very useful in engendering more responsible behaviour and less financial volatility

- **Check short termism incentives:** compensation structures are designed so that bonuses are paid annually even for decisions where the true profit or loss may come to light only in ten years. This rewards the 'picking pennies in front of a steamroller' kind of behaviour where transactions that produce short term return but at the cost of long term risk are encouraged. Compensation needs to be linked to the total transaction impact on profitability. Also profit making strategies that threaten the solvency of the institution and/or the stability of the financial system need to dis-incentivized.

- **Control short term focus of the financial system**: everything in finance, from the performance of employees, to the track record of hedge fund managers, to CEO performance and judgements on corporate performance is oriented towards the short term which has been becoming shorter and shorter over the years. There is an urgent need to reverse this trend and make the financial system more long term oriented through what would need to be a portfolio of tools. Some of these could be compensation structures as discussed above, tax incentives, industry standard performance metrics, transaction taxes that penalize short term trading etc.

- **Controlling conflicts of interest:** the financial industry more than most other industries is riddled with conflicts of interest and the supposed Chinese walls that exist to tackle these are grossly insufficient. Measures including mandated separation of potentially conflicting operations, tougher penalties for violation of fiduciary responsibility and closer supervision.

- **Aligning incentives:** there are particular instances such as securitization and private equity buyouts where it is critical to get actors to keep 'skin in the game' i.e. have a profit/loss stake in the outcome. Unless banks are mandated to retain some securitization risk they would not have the incentive to do proper due diligence and unless private equity firms are forced not to take all of their investment out till they exit the transaction they will not care whether the firm survives or not.

- **Penalize bad compensation practices:** Firms that continue to have bad compensation practices that may amplify systemic risk should be penalized in the form of having to hold higher capital

VII. Making the financial system more competitive, diverse and reducing public subsidy

- **Break up or disincentivize too big to fail institutions:** the financial system we have, especially after the many bank rescues and forced mergers contains a lot of institutions that are 'too big to fail' or 'too interconnected to fail'. These enjoy an inherent public subsidy over smaller institutions where counterparties and creditors know that government bailouts will not be forthcoming. This distorts incentives for these institutions which makes them take on more risk than they would without the subsidy. It also squeezes out competition. That is why it is critical that to break these institutions up so that they are no longer too big to fail. Research has shown that efficiencies start drying up after $100 billion assets so trillion dollar banks are not needed.

- **Penalize size and systemic risk:** another way of limiting size is to penalize size and interconnectedness which both bring systemic risk with them by imposing capital and other charges that grow with size. Clearly in order to be effective such charges need to be steep enough to overcome the benefits of a bigger size.

- **Regulate for competition:** it is now widely accepted that the current system of regulation has been largely captured by big financial institutions. The complexity and related expense of regulation creates

barriers for new entrants and entrenches larger players. Current regulation favours big banks over small ones, more complex institutions over simpler ones and cross border ones over national banks. This not only chokes competition but also creates higher systemic risk. There is thus a stringer need for more rigorously enforced anti-trust regulation as well as financial regulation that has creating a competitive financial system as one of its explicit objectives.

- **Regulate for diversity:** one of the major factors behind the collapse of the financial system was that too many financial institutions were behaving in the same way, raising funds in the same way, investing in the same assets and using the same risk management systems. That is why when the subprime sector started declining all of these institutions had similar incentives to try get out of the positions at the same time and amplified the price decline and the crisis. A financial system that has a more diverse set of actors is less likely to herd and is likely to be more stable. This diversity can come from different sizes, different investment horizons, different regulatory environments, different compensation structures etc. Regulation, if it seeks to standardize everything and impose uniform standards and tools can inadvertently reduce diversity in the system so promoting healthy and dynamic diversity should be an explicit goal of regulation.

- **Making users pay for guarantees:** Governments need to be careful not to socialize risk when rewards are all private so need to try and extract a fair price for providing guarantees.

VIII. Credit rating agency reform

- **Limit conflict of interest:** credit rating agencies are paid by issuers, which immediately creates a conflict of interest since credit ratings are supposed to be independent assessments and ratings agencies want repeat business. However, in recent years credit rating agencies were earning an increasing fraction of their revenues by offering consulting services including on how to structure offerings to get higher ratings. Such a blatant conflict of interest played a part in the crisis through a inflation of ratings so ratings agencies must be forbidden from offering consulting services.

- **Make separate ratings categories for different products:** while credit rating agencies have a reasonable record on rating corporate bonds, their record on rating structured products where they used the same rating scale and failed to issue caveats is lamentable. These products have a completely different risk profile so should be assigned a different scale and rated with far more conservative assumptions.

- **Change compensation structures and introduce competition:** while it would be desirable to get users rather than issuers to pay for ratings, the diffused nature of security holders makes this very difficult so another model would be for each issuer to get two ratings, once chosen by them and one through a random process. This would both increase confidence in the independence of ratings and stimulate competition.

- **Reduce the regulatory role of ratings:** no matter what the problem with ratings, they would not have caused as much damage as they did were it not for the central role assigned to them by regulators. Ratings are also procyclical. Giving ratings such a central role risks reducing incentives for investors to do due diligence. For all these reasons there is a reason to limit the role of ratings in regulations.

- **Oversee ratings agencies:** Unlike the present situation where credit ratings agencies are more or less unregulated they should be brought under regulatory oversight, the worst performing credit ratings agencies in terms of the accuracy of credit ratings evaluated periodically should have their charter revoked so as to stimulate competition, align incentives with accuracy and create space for new methodologies.

IX. Regulate financial products more rigorously

- **Set up a financial product safety board:** such a body should classify any new financial instruments in a traffic light system i.e. green for retail customers to red where products are found to serve no economic purpose and are either forbidden or have punitive capital charges levied. This can be a function under one of the pan EU regulators we have proposed above.

- **Levy systemic risk charge:** the systemic risk regulator or the product safety board should look at the risk and payment profile of products and levy a risk and complexity capital charge accordingly.

- **Stronger tracking of product types and outstanding volumes:** there is an urgent need, for increased transparency as well as better oversight for regulators to be able to have a clearer insight into the types and volumes of products and exposures that various financial institutions hold.

X. Better crisis handling and crisis resolution mechanisms

- **Set up a special legal regime for unwinding large financial institutions:** the failure of Lehman and the complexity associated with it arcane legal structure and complicated financial interconnections has highlighted the urgent need for setting up a proper legal mechanism for the orderly and efficient unwinding of large financial institutions. This would also help significantly reduce the systemic risk associated with such failures.

- **Make banks do contingency plans for failure:** just like financial institutions need to have business continuity plans they should be made to make credible winding up plans which should be approved by regulators and updated at least annually. These should take into account the prevailing applicable laws.

- **Advance arrangements for burden sharing:** at least for all the large cross border financial institutions in Europe, the colleges of supervisors and relevant fiscal authorities should agree on rough burden sharing arrangements or at least agree to a methodology of how the burden should be shared. The need for this was highlighted by the messiness of recent cross border bank rescues.

- **More authority for imposing standstills and haircuts:** any form of crisis prevention and crisis resolution authority would need to have pre mandated legal authority to impose standstills and haircuts which would help prevent systemic instability and resolve potential crisis situation with a minimum total cost to tax payers. This is necessary in order to prevent post hoc legal challenges which can impose large costs on the system and on taxpayers.

- **More crisis prevention and crisis regulation tools:** there is a need for more speed bumps, where regulators can lean against the wind, circuit breakers which regulators can enforce in periods of high market volatility and possibilities of outright bans on potentially destabilizing activities such as naked short selling especially of financial institution shares and the sale of CDS in the absence of an insurable interest.

- **Better crisis co-ordination mechanisms:** pre-emptive development of crisis coordination mechanisms and contingency plans between supervisors, central banks and finance ministries both within borders and across borders.

XI. Increasing consumer protection and protection for investors especially pension funds

- **Increase and co-ordinate deposit protection:** after the experiences of this crisis and the problems caused by having improper and insufficient and un-coordinated deposit insurance mechanisms, it is imperative for the authorities to provide high and common or at least co-ordinated deposit protection guarantees. This is also in keeping with the principles of the single market.

- **Simplify ombudsman procedures and accelerate processes for legal action:** there is an increasing amount of cross border product offering so in order to offer real consumer and investor

protection, pan EU ombudsmen procedures and legal recourse for wronged customers should be simplified and made more accessible.

- **Increase national powers to require subsidiaries:** at least until EU deposit insurance and bank operations are more fully integrated, there is a need to allow national authorities more flexibility in requiring local operations of banks to be registered as subsidiaries with their independent capital, liquidity and deposit insurance requirements.

- **Introduce rules for better management of pension funds:** company owned pension funds are often raided when they are in profit but not always topped up when in deficit. There is a need for rules for better fiduciary obligations. More and more pension funds have been making risky investments to get higher returns and there is need to issue rules for restrictions and caps on such investments for example in hedge funds and private equity. Incentives for pension funds to make longer term investments are also needed as the investment cycle has become ever shorter

XII. Tax havens, off-shore financial centres and tax reform

- **Tackle tax havens:** the secrecy and low tax that tax haven jurisdictions offer not only siphon of hundreds of billions of dollars of tax revenue but also play a role in the instability of the financial system. That is why there is an urgent need to tackle these havens and make concerted efforts to remove secrecy, share tax information and provide a high regulatory floor with appropriate information sharing. Current initiatives simply do not go far enough and a mixture of incentives and punitive measures should be devised to get tax havens to comply. These should be pursued both at the level of the EU and internationally.

- **Get automatic and multilateral exchange of information:** in the absence of proper automatic exchange of information, there will always be substantial opportunities for tax avoidance including through non tax haven countries. That is why the EU needs to make a strong push for automatic exchange of information in the first instance through an extension of the depth and scope of the EU STD to corporate structures and non interest income and to other non European jurisdictions. Also, bilateral tax exchange information treaties are inefficient and often ineffective with more than 18,000 treaties needed for the more than 190 countries in the world. The EU should make a push for multilateral information exchange first as the EU and then at a global level.

- **Legislate for a country by country reporting standard:** doing so would help tackle corporate tax avoidance by making the mis-pricing of intra company trade and financial transactions much more transparent and thus easier to detect and prosecute.

- **Push for equivalent capital gains and income taxes:** having significantly tax rates for income and capital gains is not only regressive but also encourages financial instability when individuals and financial institutions try convert income into capital gains. It encourages asset price bubbles of the kind we saw in the many housing markets where speculating on house price and stock price increase gets precedence over real investment.

- **Implement financial transaction taxes including a currency transaction tax:** such taxes which already exist in many markets in many EU countries should be implemented on a much broader basis. These have the advantage of being highly progressive, easy and cheap to collect, difficult to avoid and non distortionary because of the low rates. They have enormous revenue potential, can generate useful information flows on financial transactions and can be used as tools for financial stability both by levying differentiated rates for more risk products as well as through encouraging longer investment horizons over smaller ones. They are also a highly attractive route to making the financial industry pay for the massive costs of bailouts that it has imposed on tax payers.