EUROPEAN PARLIAMENT

COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS

- PUBLIC CONSULTATION -

Questionnaire for the public consultation on

MARKET MANIPULATION: LESSONS AND REFORM POST LIBOR/EURIBOR

by ECON Vice President and Rapporteur – Arlene McCarthy MEP

This public consultation is organised in the context of the preparation of the ECON Committee reports by Arlene McCarthy MEP based on the Commission amended proposals of 25 July 2012 for a Regulation on insider dealing and market manipulation (market abuse) (COM(2012)421) and for a Directive on criminal sanctions for insider dealing and market manipulation (COM(2012)420).

Interested stakeholders are invited to respond to the questionnaire below. To facilitate the evaluation process, concise and informative responses are welcome.

Received contributions, together with the identity of the contributor, may be published on the European Parliament's website, unless contributors object to publication of their identity or parts of their responses. If contributors do not wish their identity or parts of their responses to be divulged, this should be clearly indicated and a non-confidential version should be submitted at the same time. In the absence of any indication of confidential elements, the ECON Secretariat will assume that the response contains none and that it can be published in its entirety.

Please send your answer to econ-secretariat@europarl.europa.eu by 17 September 2012 at 12.00.

IDENTITY OF THE CONTRIBUTOR

- **Name of the person and/or organisation responding to the questionnaire:**

Transparency International Liaison Office to the EU (TI-EU)

- **Description of the main activities of the organisation:**

Transparency International (TI) is a global anti-corruption NGO with national chapters in approximately 90 countries. TI's mission is to stop corruption and promote transparency, accountability and integrity at all levels and across all sectors of society. Since the collapse of Lehman Brothers in 2008, TI has been concerned with the role of corruption in the origins and aftermath of the financial crisis.

The Transparency International Liaison Office to the European Union (TI-EU) represents Transparency International at the EU level. The mission of TI-EU is to help bring about an EU free of corruption by promoting integrity, transparency and accountability in EU internal and external policies, programmes and legislation. It achieves this through the coordination of robust EU-wide advocacy networks, generating expertise from across the EU and bringing together partners in public, private and third sectors.

TI would like to take the opportunity presented by this questionnaire to answer questions 4 and 5 only, relating to the measures needed to improve transparency and integrity in the financial sector.

TI looks forward to discussing these issues with you. If you need further information, please contact:

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Please indicate whether you object to the publication of the identity of the contributor:

☐ yes, I object **X** no, I do not object

If you object, an anonymous contribution may be published.

TOPIC 1: TACKLING THE CULTURE OF MANIPULATION

Q1: How widespread is the problem? Are there other financial instruments, markets and/or benchmarks vulnerable to potential manipulation?

What action should be taken to ensure these forms of market abuse are tackled?

Q2: What action should be taken to ensure the integrity and quality of all benchmarks, financial instruments and markets?

a. Do both benchmarks and those entities that input into the setting of the benchmark need to be regulated?
b. Are traded rates as opposed to offered rates a better basis for input? Or should a 'hybrid' approach be adopted?
c. Should the posters of rates be granted anonymity? What would be the potential downside to such an approach? Would such a status add or diminish the integrity of prices?
d. What kind of powers should regulators of the financial sector be given to set and introduce criminal sanctions for attempted or actual manipulation of benchmarks?

TOPIC 2: ESTABLISHING INTEGRITY AND TRUST POST LIBOR/EURIBOR

Q3: What specific measures should be taken at European/Global level to improve investor confidence? How can cooperation between global regulators be improved?

How can legislators ensure continuity between existing contracts which rely on Libor/Euribor (some $500 trillion of contracts) and future contracts?

Q4: What specific measures could be taken to enhance transparency and information quality in the financial sector?

Financial institutions should make sufficient information available to a wide range of stakeholders to enable them to assess the nature and size of the risks to which they are exposed. Some of this information will be confidential and should only be available to regulators and supervisors. However it is our view that public disclosure of information is still inadequate, despite the progress made in the context of Basel II agreements (so-called Pillar III disclosures).

This is important because it is both unreasonable and undesirable to have the behaviour of financial institutions policed only by regulators and supervisors. Unreasonable, because the complexity of financial institutions means that the limited resources of government agencies are quickly overwhelmed. Undesirable, because the financial crisis also revealed that the revolving doors between regulators and private institutions led to a blurring of roles, opaque decision making and conflicts of interest. Reliance on internal controls and traditional prudential supervision has failed the public before, even in the most advanced jurisdictions. The greater the number of stakeholders that can monitor an institution's performance and send appropriate signals to management, the better. Such stakeholders include shareholders, investors, other market participants and civil society organisations, who can all react in different ways to revelations of high-risk and unsustainable strategies. The information can be used to inform potential policy responses and the adequacy of regulators' approaches too can be subject to stakeholders' comment.

Financial institutions should therefore be required to publicly disclose their activities in far greater detail. A 2011 study (*Business Models in European Banking: a pre- and post-crisis screening*, Centre for European Studies: http://www.ceps.eu/book/business-models-european-banking-pre-and-post-crisis-screening) has revealed several shortcomings regarding the transparency of the EU's top banks. There is a striking lack of detailed information on risk exposures to different business sectors, customer classes and off-balance sheet entities. Even relatively straightforward data, such as loans to public bodies, loans to SMEs, foreign currency exposures and liquidity conditions are hard to find in annual reports or financial statements.

In July 2012, Transparency International published the results of an independent assessment of corporate transparency. "Transparency in Corporate Reporting" (TRAC) looked at how the 105 largest publicly listed companies in the world rated in terms of their reporting on anti-corrruption programmes, the transparency of their organisational structures, and the extent of their country-by-country reporting of revenues, payments and other contributions. 24 financial institutions were included in the sample (5 are incorporated in the EU). In all three categories, financial companies scored below average, with particularly poor results for country-by-country reporting (2.3% - 13 institutions disclosed nothing at all in this category). Further information is available here: http://www.transparency.org/whatwedo/pub/transparency_in_corporate_reporting_assessing_the_worlds_largest_companies

More detailed and standardised disclosure of banks' financial positions is necessary for a wider range of checks and balances to function, such as the ability of investors and creditors to monitor risk.

Detailed public disclosure requirements would include:

• Publishing comprehensive data on key aspects of a financial institution's risk profile, e.g., credit exposure to other financial institutions (including off-balance sheet entities and the unregulated, "shadow", banking sector), exposure to structured financial products, and concentration, market and liquidity risks.

• Reporting on group structures and relationships and transactions between affiliates, joint-ventures and other related entities, to assess mutual dependencies and the risk of contagion.

• Reporting of quarterly averages of balance sheet categories, to avoid the misleading results that sometimes accompany single-day data.

- Greater disclosure of loan performance data and the provisions made for losses.

- Disclosure by banks of the models used to value assets.

- Reporting by regulators on key elements of supervisory review process, such as stress test data, capital add-on requirements, as well as sanctions and warnings issued.

- Disclosure of payments to governments and other key financial data such as sales, revenues and profits.

In cases where it has been identified that a bank is in receipt of a public subsidy - either implicitly as a result of its “too-big-to-fail” status, or explicitly through taxpayer-funded bailouts - detailed information on the asset side of its balance sheets should be routinely provided to prudential regulators. Currently, this information is only available on request or at a level of aggregation that is inadequate to detect potential risks.

The transparency and accountability of institutions would be enhanced by agreement on a single set of international standards for asset valuation in financial institutions, in the context of developing more rigorous and transparent accounting rules more generally.

Greater transparency with regard to financial information should also to be accompanied by greater transparency in all aspects of governance and decision-making (e.g. the selection, composition and performance of board members) and incentive structures (e.g. remuneration packages, career development). Such information should be externally verified where possible.

Q5: What future action could be taken to achieve better governance in order to prevent future manipulation and establish integrity, trust and fairness in the financial services industry?

Trust used to be a word associated with banks. But the avalanche of financial scandals, from manipulation of interest rates to mis-selling of financial products, has changed all that.

What is required is a strong and transparent financial sector that we can trust, one that is corruption-free. This requires an overhaul not only in the regulatory environment, but also a resetting of moral compasses by those in the industry.

Remedying this situation requires both structural reforms – addressing the “too-big-to-fail” phenomenon that incentives banks to take risks with public money – but also improvements in governance and incentives in individual firms.

The processes that characterise strong corporate governance systems align in many respects with the key elements for countering bribery that have been outlined in the Transparency International (TI) policy positions on corporate governance. Anti-corruption principles are a vital part of effective corporate governance because they underline the need to take seriously the long-term viability and interests of the company and its stakeholders ahead of the interest of the board or management in generating short term gains or inflated remuneration and bonuses.

TI acknowledges the steps the European Commission has taken in the proposals currently under discussion in the Capital Requirements Directive IV and Market in Financial Instruments Directive (MiFID) to improve risk management and corporate governance in financial institutions, and, in the case of banks, to moderate variable remuneration. We would encourage the Commission, European Parliament and Council to continue and extend this work on remuneration, for example by examining actual levels of compensation in the sector and the use of "clawback" clauses in contracts.

Trust in the banking sector can only be restored if it is perceived that regulation is in the public interest and is being enforced impartially. Concerns have been expressed about about the financial industry's "capture" of aspects of the regulatory and supervisory process (cf. Simon Johnson, former IMF Chief Economist, http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/307364/) through such mechanisms as lobbying and the easy mobility of senior staff between private financial institutions and regulatory agencies (the so-called "revolving door"). The lack of regulation in this area has been highlighted in the Transparency International 2012 report "*Money, Politics, Power: Corruption Risks in Europe*", which assessed corruption risks in 25 European countries. Governance reform should also address this issue.

Specific reform measures should include:

- The requirement to publicly report on corporate governance structures, including anticorruption systems, overall operations and performance. Greater transparency in this respect is beneficial in encouraging higher standards of behaviour and establishing the legitimacy of the company as a responsible enterprise in society.

- It should be made clear that the management body is responsible for ensuring that remuneration schemes – both for employees and senior executives – do not contradict policies that promote integrity and the long-term sustainability of the firm. The management body should also ensure that recruitment, training and promotion policies are also consistent with the promotion of integrity and a sustainable management culture. Firms should report regularly on measures they are taking to implement these policies.

- Specific board responsibilities should be designated to oversee corporate governance, as well as ethical and integrity issues, taking account of the size, scale and complexity of the firm and its activities.

- There should be explicit mention in of the management body's responsibility for the oversight of internal controls and state-of-the-art compliance systems to ensure that decisions are taken with integrity and in the best interests of investors. Those controls and systems should pay particular attention to the role of third parties and the appropriate due diligence should be carried out. Recruitment policies and criteria should reflect the need for members of the management body to have the necessary skills and capacities to carry out this function.

- Effective reporting channels and protection for whistleblowers are critical elements of a firm's internal controls. TI welcomes the proposal that these be made available to staff members in investment firms and that competent national authorities encourage reporting. The current proposals, however, are limited to reporting breaches of legislation. The whistleblowing facilities and protection should be extended to cover other areas of concern, such as excessive risk-taking or irregularities that are not clear breaches of the legislation. In line with the recommendations in the G20 Anti-Corruption Action Plan, the proposal should further emphasize the need for disclosure mechanisms to be easily accessible and that reports need to be followed up independently and without major time delay.

- In addition to limiting the number of concurrent directorships held by members of an investment firm's management board, consideration should be given to measures that would limit the *duration* of the mandate of directors and ensure that that the board's membership is refreshed periodically. This would reduce the risk of 'group think' and help to promote the contrarian thinking that enables the board to carry out its functions properly.

- Good governance is also a matter of improving the relationship between owners and management by strengthening shareholder democracy. This helps to create an accountability mechanism that combats corrupt and unsustainable actions by senior management. Shareholder rights should be reinforced and their participation in company meetings facilitated, including voting on changes to a company's structure (articles of incorporation) and important board decisions (board membership and remuneration policy).

- Measures to make clear the responsibilities of senior executives should also be considered. The governance of financial institutions would be enhanced if their fiduciary duties were extended beyond the concern with shareholder maximisation, to make it explicit that they are responsible for the safety and soundness of the institution over the long-term. Furthermore, it should be made clear that overall accountability for risk management programmes lies with the board in its entirety.

THANK YOU FOR RESPONDING TO THIS QUESTIONNAIRE.