Report on Wilton Park Conference 939

RESTORING CONFIDENCE IN GLOBAL FINANCIAL MARKETS
Friday 21 – Saturday 22 November 2008

in association with European Financial Forum, EFAMA, Paris Europlace and Deutsches Aktieninstitut

This conference, the eleventh in an annual series, was chaired by Professor Eddy Wymeersch, chair of the supervisory board of the Belgian Banking, Finance and Insurance Commission and chair of the Committee of European Securities Supervisors (CESR).

Looking Beyond the Crisis

1. The crisis was becoming more and more worrying as it spread from the financial to non-financial sectors. After a period of rapid growth, the financial sector has performed extremely poorly; so too have supervisory structures. Some felt it was the inadequate response of the regulators to the difficulties in the sector that had triggered the deepening crisis. The macro economic downturn had now become the main source of risk to all asset classes.

2. Among the main lessons learned are the importance of keeping a lid on leverage and the need for greater market transparency. Supervisors needed to have a general insight into all financial activities including hedge funds and off balance sheet vehicles. Risk management had to be improved with a wider remit for risk committees including monitoring the connection between micro risks and macro. Corporate governance had also shown its limitations as checks and balances have failed. Dominant CEOs had been given too much latitude and the interests of

managers and shareholders have been misaligned. However shareholders were not just victims; they also had been too inactive.

3. A number of questions now need to be addressed. The basic business model for banks needed to be reviewed, over the counter markets need to be made more open, and there needed to be a review as to whether fair value accounting is the only standard. The design of compensation schemes also needed to be reviewed. The composition of Boards needed to be reviewed including the role of inside directors versus outside directors. There was a need for Boards to be able to dig deeper for information inside the firm.

4. Actions were being undertaken in many of these areas. There was world wide agreement on the monitoring of the processes of credit agencies, a voluntary code of best practice had been established by hedge funds, a reflection on fair value accounting has been launched and proposals were expected from the EU Commission on remuneration. The Committee of European Securities Regulators (CESR) has established new work streams in areas such as accounting. Institutional changes in Europe's supervisory and regulatory structures were also taking place and further changes were under examination. Centralisation was not necessarily the answer but more coordination had to take place. 'Level 3' committees such as CESR were already developing a stronger co-ordination role. At the same time the answer was not just more regulation, the need was still for 'smart' regulation.

Strengthening Market Resilience

5. Greater transparency was seen as a key to strengthening market resilience and emergence from the crisis. Supervisors and markets needed greater information on issuers, products and non-transparent parts of the market.

6. As far as issuers were concerned much of the debate centred around fair value accounting. Fair value accounting had been criticised for providing inappropriate guidance in distressed and illiquid markets and for helping to cause destabilising spirals. But it was important that financial information did not become a

prudential tool and International Accounting Standards Board (IASB) processes needed to be respected. In this connection a number of discussants emphasised the need to hold firm to fair value accounting as it is critical to investor confidence.

7. Greater transparency about products would involve greater disclosure for structured products but also revised rules for mutual funds including revised rules on liquidity risk and harmonised definitions of money market funds. There would need to be improved oversight, ideally on a global basis, of credit rating agencies.

8. European markets need in particular to revise policies on non-equities post-trading transparency. This would enable the performance of institutional investors to be better monitored and would facilitate the valuation of complex instruments.

9. In distressed markets not everyone attached the same weight to transparency. This provided an argument for considering further the so-called ‘twin peaks’ regulatory approach where prudential supervision was separated from conduct of business oversight.

10. Investors, regulators and central bankers had all become far too dependent on the opinions of credit rating agencies. Investors had used them in an over-simplistic way; regulators had ‘hard wired’ them into their rules, and central banks turned to them for their funding facility and collateral rules.

11. The Securities and Exchange Commission (SEC) is now proposing to eliminate rating references from its rules and it was suggested that the market resilience would be strengthened if investors and central banks also weaned themselves from their dependence. In this context that greater regulation of credit rating agencies involved movement in the wrong direction because it would give them even greater standing. Instead there was a need to look at alternatives including the development of measures that were not just limited to the risk of default but also measured other aspects such as liquidity risk and volatility. However, credit rating agencies were deeply embedded in the market, and some degree of public oversight was therefore necessary. At the same time some of the damage done by

the ways in which they had become embedded could be undone and there was a need to look again at balance between their role in helping markets to appraise idiosyncratic risk against their role as a source of systemic risk.

12. As part of a return to fundamentals where market actors took greater responsibility for the own credit decisions, there would need to be a clearer distinction between 'simple' banks, financial institutions offering basic, standardised products (acting like public utilities), and those financial institutions offering complex products. There was a role for both kinds of financial institution as well as innovative and basic products. It was also pointed out that the design of products was a client driven process and some clients wanted complex products. Others suggest the desire for 'simple' banking is a false road.

The Future of Investment Management

13. Undertakings for Collective Investment in Transferable Securities (UCITS) have performed well but investment mangers are facing extremely challenging market conditions with results to be expected in line with the sharply declining financial downturn. Investment Managers need to rethink their investment strategy including how to treat customers fairly; how to offer clients greater protection in adverse markets (particularly for pension products); how to close the gap with distributors, and the role of the buy side as shareholder activist. Good structuring will remain key for treating clients fairly. The role of money market funds needs to be reviewed and greater focus placed on long term investments. New types of risk, for example liquidity risk, have emerged. Cost-cutting exercises will be key in the coming months. Boards have been too passive and have not performed well but there is no consensus on remedies.

Basel II

14. The present crisis was more a crisis for the Basel I approach to capital adequacy than the risk based Basel II approach. While it is premature to criticise Basel II, at the same there was support for the further work being done to strengthen

current guidelines. In particular excessive leverage from both on balance sheet and off balance sheet activities needed to be contained. Maximum leverage ratios were thought to comprise too blunt a tool but some kind of funding formula needed to be developed. There was also support for building in additional shock absorbers into the capital framework of banks and for enhancing the quality of their capital, but also some concern also that the framework could become too restrictive.

A New Bretton Woods

15. The discussion of the recent Group of 20 (G20) heads of government meeting revealed two main concerns. First there were concerns about the process. Long preparation times were needed to ensure well thought out reform proposals, and it was unclear how the necessary work was to be done between working groups of the G20 itself and other bodies such as the Financial Stability Forum (FSF) and International Monetary Fund (IMF). It was also unclear how institutional reforms under consideration in the EU would play into global processes. Secondly there were concerns about the content of the agenda. There needed to be a long term perspective focussing on a relatively small number of fundamental issues such as the possible need for a global coordinating council for financial regulators under the FSF. There was as yet no consensus on what these topics should be.

Incentives and investor Protection

16. There is a need for a strong and independent risk management function at the centre of the firm with direct access to senior management and the Board. The function should not be too fragmented and had to be strong enough to challenge preconceptions. It should be properly remunerated in relation to other key corporate activities. Corporate 'memories' were often defective or non existent and there was a role for 'seasoned veterans' who could take an overview of risks and provide historical perspective.

17. As underlined by this year's Institute of International Finance (IIF) Report on effective global regulation, compensation needed to be linked to returns over the

long term (and not to short term gains that might later turn into losses) and to firm-wide profitability. Remuneration structures that contained only upside potential provided asymmetric incentives. It was important to have independent oversight of practices within a firm. A number of reviews of compensation principles and structures were underway around the world and in the meantime regulators were intervening to make their views known.

18. Uneven regulation of different market sectors and markets had contributed to both problems of risk management and remuneration. At the same time regulators needed to recognise that the complexity of products was not a problem in itself, but only when badly explained or inappropriately distributed. Again uneven approaches by regulators to product regulation had contributed to problems.

19. Regulators had to be prepared to let firms fail since otherwise investors would not learn from their mistakes. At the same time it had to be recognised that along with ‘house owning democracies’ and ‘shareholder capitalism’ more people were at risk from failed firms and failed products so that the social dimension of financial crises could not be ignored.

The Transatlantic Dialogue

20. The transatlantic dialogue has been overtaken by the need for global dialogue. This in turn has moved to focus on key centres and markets in the G20. The EU itself had widened its own bilateral dialogues to include Japan, Russia and India and these would continue. In this connection, it was important to recognise that global standards were not a matter of pure science but reflected different situations and different underlying philosophies. The costs and benefits of global standards also differed between jurisdictions. Global standards were therefore inherently difficult to frame and implement.

21. At the same time as the need to respect differences in approach there was a widespread disapproval voiced about the way IASB had been subjected to political pressures and forced into making changes in response to the crisis. On the one

hand core principles needed to be respected in bad times as well as good. Quick adjustments reduced market transparency and damaged confidence. On the other hand in situations of crisis and market break down, there were limits to standards. A crisis required speedy responses such as that of the European Commission in respect of modifications to fair value. In an emergency, in the absence of a global regulatory authority, national regulators simply had to act.

22. Governance structures at IASB were being addressed through the appointment of a Monitoring Board so that the concerns of regulators and supervisors in key jurisdictions could be taken into account. IASB was not just acting as a private rule maker but sought to factor in the public interest. Nevertheless independence and due process were critical. Emerging issues also needed to kept free of political pressures. These included the treatment of 'goodwill' on balance sheets and impairment. Given the crisis, there was also going to be an immediate issue in terms of the quality of 2008 accounts. The circumstances that necessitated independence of Central Banks through much of the world was also needed in respect of the IASB so that its mandate could be understood and protected. The European Commission's new consultation paper on auditing standards (to be commented on by 28 February 2009) and more international dialogue can help the process.

Risk management in the European Investment Fund Industry

23. Supervisors in several jurisdictions including the EU, US, Canada and Australia were making a major effort to see that better information was delivered to investors. In the context of the UCITS review, French and British regulators were together with others producing a kit setting out key information for investors. There was in addition a need to make similar progress over a wider front so as to include not just asset managers but also life insurance and banking products.

24. The industry needed to be more proactive in bringing solutions to regulators. For example, in recent years the quality of credit analysis had suffered in the process of disintermediation, liquidity management had been poor and maturity mismatching

also remained a concern. Another area of concern to regulators was the quality of advice received by investors. In this context, suitability tests, mandatory under the Markets in Financial Instruments Directive (MiFID) were crucial so that investments were matched to the risk profile of clients and their life cycle preferences.

25. In this context, the investment management industry was still adjusting from a world of standardised products to a principles based approach where there was much greater flexibility in the choice of investment instruments. At the moment performance was poor but there had been few product failures. At the same time risk management was having to cover new areas such as issuer and counterparty risk and liquidity risk. In particular there was a need to build bridges between the use of less liquid instruments and the need to observe redeemability rules. There was a risk that a process of redemptions could leave asset managers with unbalanced and illiquid portfolios. More emphasis could be put on liquidity and redeemability management, and asset managers should avoid certain classes of illiquid assets.

26. Risk management was not only a question of the integrity of portfolio management but the crisis had also underlined the importance of operational risk management including such aspects as trade settlements and the role of custodians. There is a strong concern that as the recession deepens operational risks will increase, especially those involved in bankruptcy and resolution. It was not simply a question that bankruptcy law was outdated in many jurisdictions, but also a question of poor documentation and lack of clarity about the role of depositories and custodians.

27. The asset management industry is in a completely different position from banks. Asset managers had a primary duty of care towards their clients. Looking beyond the crisis it was clear that a new generation of products needed to be developed to take account of greater longevity and better health. The industry had to be forward looking in its approach to investments and products. There was a strong demand for different types of asset and an opportunity to create new products; at the same time there was a need to protect the reputation of the UCITS

brand and not to risk reputational damage. The costs of doing business would also be going up. As a result, scale would become increasingly important and the industry would need to be restructured. A new regulatory framework would be needed for longer term investments.

Frank Vibert
December 2008

Wilton Park Reports are brief summaries of the main points and conclusions of a conference. The reports reflect rapporteurs' personal interpretations of the proceedings – as such they do not constitute any institutional policy of Wilton Park nor do they necessarily represent the views of rapporteurs.