Report on Wilton Park Conference 1005 in association with European Financial Forum (EFF), European Fund and Asset Management Association (EFAMA), Paris Europlace and Deutsches Aktieninstitut

BUILDING A NEW BALANCED GLOBAL SYSTEM OF FINANCIAL MARKET REGULATION

Friday 30 – Saturday 31 OCTOBER 2009

Introduction

1. This conference, the 12th in an annual series, was chaired by Dr Hans Hoogervorst, Chair of the Netherlands Authority for the Financial Markets (AFM) and addressed by Jacques de Larosière, Chair of the EU High Level Group on Financial Services Regulation.

2. Speakers frankly assessed the future prospects, EU and trans-Atlantic issues and the underlying principles behind financial services regulatory reforms. It was encouraging that in Europe the Commission had moved so quickly to implement the de Larosière report in an almost unprecedently speedy fashion. The Swedish presidency was moving towards a conclusion in December. But there must be a fear that not enough would happen in practice. A dramatic and selective tightening of bank capital requirements was essential; this would be resisted by a politically influential profession.

3. Another concern was the pace of reform. Basel needed to move from a cycle in which it took twelve years to implement capital reforms to one in which it could be done in twelve months.

4. More generally there was concern about the potential mismatches between EU and US policies. One way to address this would be to create a treaty along the lines of the regime which prevailed in the World Trade

Organisation (WTO). Such a treaty would have rules, procedures and an appellate system. If this could not be achieved, given the importance of and poor record of consistent enforcement to date, it would be desirable to equip the International Monetary Fund with a mandate to police the system. Alone of the international organisations it had personnel equipped with country inspection and supervision and was much more able to do this than for example the Organisation for Economic Co-operation and Development (OECD).

5. A sharp distinction was drawn between the use of selective capital requirements and leverage ratios. A universal liquidity ratio would serve little purpose: liquidity numbers were valuable as indicators rather than as automatic policing mechanisms. They should alert supervisors to potential problems and attract their attention.

6. Looking at the background, the objective was to create in Europe a common rule book to replace a system which had become a patchwork with significant national exemptions. The Lamfalussy committees needed to be strengthened. The proposed model would allow them to solve and eventually decide where there was a difference of views in the College of Supervisors with binding interpretations. However, there was no backdoor 'creep' to a single European supervisory authority. Peer pressure alone was now not sufficient but the de Larosière report had avoided the 'war' of whether there should be one, two or three agencies. The trend was now probably towards a twin peak system as applied in the Netherlands, France and Spain.

7. The role of the European Systemic Risk Board was to give a view "from the top of the mast" of emerging dangers. The European model was different from the Obama/Geithner proposal – they were only looking at institutional issues rather than the whole macro-economic dimension although this had been modified to some extent in the June Pittsburg G20 communiqué.

8. Overall there was confidence that increased capital ratios would happen but the need to be alert to liquidity problems was critical because most crises began with liquidity rather than solvency issues. System design needed to understand the way in which banking groups worked and to avoid becoming confused by differing liquidity levels in the centre or subsidiary levels of banking organisations. Through dynamic provisioning on the profit and loss account pro-cyclical problems could be mitigated, on Spanish lines. Consolidation of off balance sheet transactions would also assist.

9. The current focus on regulating hedge funds. They had not presented a systemic problem. If they had moved from having $4 billion of assets to $1 billion today then that massive loss had had no systemic impact and no consequences for taxpayers. Hedge funds some argued, are transparent institutions. They are upfront about their role in speculative transactions. If people invested in funds which didn't perform this task well; they would lose their money, but this was not a public policy problem by contrast with commercial banks behaving in this way. The focus, many argued, should be upon curbing bank proprietary activities.

10. Centralising clearing of derivatives was perhaps a good idea, but was also not much to do with the crisis. More clarity and transparency would, however, assist as would regulating rating agencies more closely and improve the compensation practices of banks.

11. The European Commission had emphasised that it would not increase capital requirements more than was necessary. The various individual capital requirements on banks would imply a potentially substantial overall impact. This would come against a background of an already weak long-term trend for growth, estimated by the Commission at 1% per year before the crisis. The trade-off between financial stability and potential economic growth must be acknowledged and where possible quantified.

12. More generally, the EU banking system had been stabilised, but large parts of it remained on 'life support'. Any exit strategy could only be safely executed once banks' balance sheets were sufficiently robust and estimates by the International Monetary Fund (IMF), the European Central Bank and the Committee for European Banking Supervisors. All suggested that the balance sheets of EU banks currently remained vulnerable to further substantial write-downs in asset value and credit losses.

13. If banks did not seize the current window of opportunity to repair their balance sheets by writing down assets and building up capital, economic recovery could be choked off in a replay of the Japanese experience of the 1990s. Choosing the moment for effective exit was very difficult for policymakers. They would be required to look forward and make intelligent guesses about likely conditions at chosen exit dates. Sequencing, which is difficult even in a normal policy setting, would be challenging in phasing out fiscal and monetary policy stimulus. Central bank liquidity measures and government guarantees may need to be staggered across countries with the risk of distortions in market functioning and competition on the way out, just as on the way in. Policymakers and market participants must be willing to accept early warnings, share information and accept mediated outcomes if the new institutional arrangements are to work.

14. The European single market had survived the financial crisis. A couple of cross-border institutions had found themselves in distress and burden-sharing agreements were reached among the member states concerned. But there was a live debate on whether burden-sharing was the basis for a more incentive-compatible framework for managing cross-border crises. Legal structuring of cross-border financial institutions and constraints on their activity linked to the budgetary capacity of the home country was another way forward. Burden-sharing implied politically sensitive decisions relating to the pooling of tax bases and national sovereignty in crisis situations. The other approach however implied a retreat from the existing model of financial integration to a more segmented and hence less cost-effective and

competitive internal market. Possibly early intervention and living wills would bridge the gap between these two strategic approaches.

15. As far as the US was concerned, there may have been a tension between system incentives aimed to promote competition and financial stability: more competition had tightened profit margins, increased leverage and also perhaps increased incentives for fraud. Some products could be sold without registration or trading on a transparent exchange. Some over-the-counter (OTC) products were difficult to value if no-one knew who was holding what basket of risks at any time. With risks difficult to monitor, managers may be tempted to take on more.

16. Against this background, the new US approach would replace trust with information, rules and vigorous enforcement. Some participants queried whether there was in fact a new 'system' emerging in the US. There was disappointment that more progress had not been made in addressing insurance at federal level. Some did not believe that OTC products should be exchange traded. It should further be considered whether securities markets had functioned well.

17. In the US context it was agreed that hedge funds had not been instrumental in the crisis, but would be regulated in future by the Securities and Exchange Commission (SEC) with prudential requirements.

18. Private sector participants were concerned less there were mismatches between the content and timetable for re-regulation in the US and the EU, or even whether some EU measures such as the Alternative Investment Fund Managers (AIFM) Directive would effectively shutout US players. Officials thought it was early days; agreement on the objectives of hedge fund regulation had not yet been secured but there was confidence that the dialogue was proceeding along parallel lines and would not result in distortions leading to opportunities for regulatory arbitrage. In many fields, it

was argued, ultimate enforcement could not be mandated at the global level but came down to peer pressure and moral suasion.

Underpinning markets – stable regulation for market institutions

19. In the UK it is argued, in the regulatory and institutional structures and approaches introduced in the late 1990s had suffered from gaps which may not have been apparent at the time. The Bank of England, for example, had identified several issues on risk but lacked powers to intervene. The Financial Services Authority (FSA) did not have the tools to create effective linkages with macro-prudential regulation.

20. A Conservative government would hand macro-prudential regulation to the Bank of England as well as prudential supervision of systemically important issues. This twin peak approach was also deployed in the Netherlands, Australia, France and would be introduced in Germany. It would be important to establish an integrated structure with single points of contact. Future governments would aim to be active participants in the G20 and would think carefully about the precise role of the EU. Recent events had shown a weakness in political leadership in this field. It was believed a Conservative government would deploy a Treasury Minister in a closer engagement with EU Institutions. It would, for example, seek to influence Directives like the measure on alternative investment fund managers earlier rather than later. It is important in designing regulatory architectures to note that the people who pick up the tab are national taxpayers.

21. Regulators' perspectives suggested that crises construct the case for reform – whether in the 1907 panic which led to the Federal Reserve Act in the US, the Depression of 1929-33 which was followed by Glass Steagall or the 2007 crisis which has led to the G20, recommendations from a Financial Stability Board, a raft of EU and US proposals and proposals for reform.

22. There would be a very significant increase in requirements for core tier 1 capital with a counter-cyclical buffer also required of institutions. The outlook for liquidity regulation would require a focus on asset liability mismatches, limits on lending long and borrowing short, a focus on core funding ratios and attention to asset encumbrance and a collateral budget. There would be the determination of a liquidity buffer to mitigate remaining liquidity risk and develop contingent funding plans.

23. Micro-supervision would have to be proactive which would involve judgement, making tough calls and forward looking taking possible economic stress into account, if need be it would have to be intrusive. Macro-supervision meanwhile would look at the entire system, identifying risks, issuing warnings and assuring follow-up. Special resolution regimes would need to review infrastructure and netting arrangements.

24. There were some open issues. Macro-supervision measures must be taken to mitigate risks which had been identified and which may be hard to find or lurking in areas where authorities are reluctant to look. Capital and liquidity regulation would have a trade off in economic performance. Stricter regulation of big banks and special resolution regimes were the likely response to too-big-to-fail issues.

25. Many market participants warned that there was a risk of regulatory overkill. In particular, if we were not sure what systemic risk was exactly there was a particular risk of regulatory overshooting. There was a sharp comparison between the Undertakings for Collective Investments in Transferable Securities (UCITS) IV measures (which had key investor information, provisions for a management company passport, pooling and systems for cooperation between regulators with an example of serious over-regulation), and the AIFM Draft Directive which had particular problems because of its one-size-fit-all approach to instruments, its rigid rules on depositories and delegation and its discriminatory approach to AIF's domiciled in third countries.

26. Whilst many agreed on the goal of restoring and safeguarding financial stability with especial attention on capital requirements, leverage restrictions, liquidity pro-cyclicality and special provisions for systemically important firms, the multitude of potential approaches and measures illustrated in the chart showed the danger of introducing regulatory overkill. This rising tide meant that future financial regulation would be tighter, broader and deeper with areas which used only to be the domain of management coming under close scrutiny. Despite international coordination efforts the risk of regulatory fragmentation remained high as the implementation timetable and priorities could well differ across jurisdictions.

27. Whether or not banks were receiving direct support, the viability of the financial system overall was currently the result of the government guarantees, special intervention, asset support and quantitative easing. This had a real consequence on the autonomy of financial institutions which perhaps most visibly occurred in pay where bonuses should clearly be paid in share capital rather than cash. The worst thing bankers could do would be to ignore public sensitivity on this area: the consequence would otherwise be a wish to go much further with intrusive regulation.

28. It was important also to draw a clear line between what was needed from prudential regulators and some of the broader discussions. The prudential focus should be on capital conservation and the maintenance of approaches consistent with effective risk management.

29. Concerning the position of insurance companies in the regulatory system, many felt that it was not a straightforward matter to make a clear distinction between systemically important insurance businesses and their counterparts in the banking sector.

30. Reviewing the international system, there were good inter-linkages between Lamfalussy committees and the Financial Stability Board. The

relationships between the successors for the Lamfalussy committees and the Commission were to some degree dependant on legal rules which precluded agencies from taking particular tasks. The Commission's intention was to act on advice from the agencies rather than to make any grab for power itself.

31. The key points concerning potential conflicts of interest within central banks between monetary policy and financial stability was to first restore trust; and secondly extract a return for taxpayers currently invested in financial institution. Designing a system as clear as possible from conflicts of interest would require skill. Participants were not on the whole persuaded that current plans had yet achieved this clarity.

32. Some expected pressure to include all insurers, for example, in the Bank of England regime and an incoming UK government would have to look at this very carefully. The opposition had already set up an implementation advisory group to address these sort of issues. It was important also to devote serious attention to the conduct of business and consumer aspects in a new regulatory system with a clear focus on supporting and advising consumers. Over the next few months this debate could be expected to take place in consultation with the industry.

The outlook for fund management

33. The future of hedge funds attracted considerable debate. They would emerge stronger, participants argued, because investors who should not have been in the area had departed; there have been no demands on the public purse; and their innovation, market efficiency and specialisation would be in demand. The EU's AIFM Directive was criticised heavily: it had strong protectionist elements, lacked proper impact assessment, had been drafted without sufficient understanding of the sector, and applied regulatory approaches which were more suitable to banks.

34. In asset management the industry had survived and the mood was brighter. But it would be a mistake, it was argued, to go back to the cosy world before the crisis. Asset managers needed to be much clearer about their value added; their treatment of diversification; whether they did indeed offer safe access to sophisticated investors; how professional they were and how they handled the provision of liquidity. They had to prove again, in short, their value-added.

35. Managers had discovered that they didn't know their customers as well as they had thought and that they had a number of serious competitors. These included banks. People could sell fund and buy money market products. Whilst the sector had avoided the regulatory tsunami which was threatening the banks, they needed to reflect upon it and clarify precisely where these funds would fit in the new regime.

36. Consistent out-performance over time in investment management was difficult. Successfully combining talent, culture and process to create value in the sector is difficult to achieve and relatively fragile. In the US there were still opportunities for further household penetration even though 52.5% of US households now owned mutual funds. With 50% of all households earning more than $50,000 a year and 32% more than $75,000 a year there was still scope for growth. Mutual funds are the largest single financial asset purchased by US households. The US provided 51% of the worldwide market with Europe at 33%, Asia-Pacific at 11% and other Americas at 5%. It was argued that in the US the vast majority of fund flows have been to existing funds not to newly introduced funds which was the case in Europe and the USA. Some participants felt this could indicate a danger of mis-selling. Larger funds tended to have lower total expenses due to economies of scale and healthier average assets per fund in the US tended to drive down costs for US fund shareholders. The data implied that more expensive funds as a group suffered net outflows.

Rebuilding trust: the role of auditors and part to be played by exchanges

37. In an assessment of the systemic importance of the big four audit firms it was noted that these had over 90% of market share, were increasingly regional rather than national in organisation and had cross-border decision-making and resource management capabilities. The loss of even one large firm would be a high impact event for capital markets because of reduced availability of high quality control; significant costs for markets; and uncertainty and a threat to financial stability. With significant barriers to entry the duration of this policy risk, it was argued, is long term and the risk has been assessed by the big four firms themselves as 'significant'.

38. The policy options for response to these risks were examined including supply and demand side measures and reduction of uncertainty and disruption costs in the event that a firm leave the market. There were significant gaps in oversight of international firms and networks with their holding companies. However, the International Forum of Independent Audit Regulators was contributing to the discussion. Potential improvements included risk managements systems, capital adequacy and living wills with a review of barriers to entry and market wide contingency plans. One way forward might be for the Financial Stability Board to commission a fact finding exercise.

39. Participants compared appropriate approaches to accounting firms and financial institutions. Recapitalisation would not work, for example, for accounting firms in the same way as for banks because they were private partnerships. There was no way to flood the accounting market with liquidity. It was difficult for states to provide some form of guarantee. So the techniques for financial markets generally were not really available for the audit market.

40. Exchanges had been relatively stable during the crisis period; on the whole promoted the key concepts of trust, integrity and transparency. Their standards, market surveillance and supervision and equality of access were

important. IFEA should grow and be nurtured, participants agreed and it was felt that the buy side should be more involved. In the EU it was not as sophisticated as in the United States. The MIFid Directive, created at the time of a bull market, had prioritised competition rather than stability. Yet exchanges had provided stability and liquidity when other sources had dried up, and securities had been traded at all times although there was unpleasant volatility. In short the exchanges had done their job.

41. The challenge now was to strengthen investment in exchange capability and use the legal framework to strengthen their role. They are as important as central clearing facilities in risk management, although some argued that mandatory registration of open risk derivative contracts was now necessary.

42. Although some criticised fragmentation it was the price of competition. Market participants must appreciate that in order to provide the transparency which revealed values and prices effectively there was a need to pay for exchanges in a sustainable way. The importance of transparency loomed large as it was difficult for regulators ex ante to identify where excessive risk taking was likely to take place. However, the industry should be able to use transparency techniques to reveal where moral hazard was operating. Some participants felt, however, that the discussion had not captured the full extent of the public anger with financial institutions, the need for banks to apologise and to recognise that the environment had been transformed once taxpayers became major shareholders.

New products to fill gaps in the markets

43. Innovation would always be present. It was not possible to imagine a world without securitisation or derivatives. Pooling of assets was one of the basic tools of finance. There is a discrepancy between the financial world as it is and the world of academics who had a significant influence on policymakers. Innovation need not lead to complex products – simple funds

put any market at the disposal of anyone in the world at low cost. Some felt The European Fund and Asset Management Association (EFAMA)'s campaign for more regulation of structured productsshould not be seen as competition for traditional funds. They would only become competitors if regulated and regulation could well, it was suggested, make life worse for asset managers. Some saw a bright future for hedge funds which gave a full view of portfolio issues and allowed better deployment of knowledge and strategies.

44. In an examination of the state of the market, people asked who was the real end customer. In the perception of some participants funds were 'sold' rather than 'bought' and 95% of the decisions as to what reached the end client was made by a distribution network. Banks tended to sell, this line of thought argued, the easiest products with the highest margins and the distribution network with a 2-3 year cycle was somewhat at odds with the industry's claim to be selling for long term investment of 15-20 years.

45. Some argued that whilst the three-letter-acronym class of products had produced disappointing results during the crisis, UCITS had passed the real stress test with Bravura. The tension between recent customer experience with products which were effectively state-guaranteed by central banks and the uncertain record of the distribution chain concerned a number of participants. It would be very unfortunate if in the future people would only de facto state-guaranteed products. US experience with the implicit state-guarantee through Fannie Mae and Freddie Mac was a disturbing precedent which merited reflection.

Conclusions

46. Two years on in the financial crisis, the worst seemed to be over. Some wondered whether this had also led to the end of a sense of urgency for change. Participants had been honest about the power of banks to resist reform and on the shortcomings of their own sectors. There was an enormous

amount still to be done. Basel III remained very unclear. There were important tradeoffs between the selective capital increases necessary for sustainable banking, and general economic growth in society. Regulators were very aware that the financial services industry could find its way around clumsily-designed measures at great speed. Central bankers believed that there was going to be a need for some brutality in raising capital requirements significantly above yesterday's prevailing norms. The redesign needed to recognise how incredibly intrusive regulation could be in the financial markets. Participants wanted to move proprietary trading out of the banking sector: this could solve many issues including conflicts of interest in OTC markets and it would reduce the too-big-to-fail problem. There is as yet no consensus in international bodies, however, on this approach. There was a consensus that over-the-counter markets should be more transparent but many felt that with customised and specialist products it was difficult to bring these to a more open structure. It was however hoped that the new regulatory approach to certificates of deposit in the US wouldn't have too many loopholes. In the balance of power between financial services authorities and central banks the general mood supported a shift towards a greater role for central banks but this was no guarantee of success in itself and it was disturbing that many saw a mass of new products as an early indicator of mis-selling at the retail level.

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