



Financial Regulation and the Dynamics of Savings and Investment Markets

European Financial Forum

Rapporteur's Summary of the discussion at Cumberland Lodge

3 - 4 November 2011

Introduction

1. This annual off the record conference convened by the European Financial Forum (EFF) in association with the **European Fund and Asset Management Association (EFAMA)**, **Paris Europlace**, and the **Association for Financial Markets in Europe (AFME)** was the first to be held at the Royal House of Cumberland Lodge after a successful 13 year series at Wilton Park. The conference brought together senior market participants, regulators and officials from ten countries across Europe plus senior representatives from the **European Commission**, Brazil, India and the Hong Kong SAR to discuss international capital markets and their regulation. Acknowledging the need for appropriate regulation, but concerned about the implementation of new regulatory requirements, the meeting focused much of its attention on the three new European Supervisory Authorities (ESAs), namely **the European Banking Authority (EBA)**, **European Insurance and Occupational Pensions Authority (EIOPA)**, and **European Securities and Markets Authority (ESMA)**, and the impact their work and global regulatory developments would have on the financial services industry in the European Union (EU), US and Asia in particular.

Executive summary

2. The global Group of 20 (G20) consensus on financial regulation appears to be weakening – attention now focuses on macro issues, namely the Eurozone crisis which has potentially very serious implications for the global economy. The gravity of insufficient economic competitiveness dwarfs the importance of resolution and macro-prudential regulation. At the heart of the Eurozone crisis is much of the EU's loss of competitiveness against Germany. Germany faces an existential crisis – it must choose between a massive bailout of the EU and inflation. Much depends upon whether Germany agrees a bailout fund which is enough or the European Central Bank (ECB) intervenes even more substantially in the sovereign bond markets. There is a considerable gap between the world of policy-makers/legislators and markets, and democracies are demonstrating they have limited ability to deal with the crisis. Increased populism on both the left and right and nationalism are having an adverse impact on the quality of legislation and regulation. The pace of globalisation in financial services has far exceeded the establishment of institutions of global governance and supra-national policy-making. Financial regulation alone is not enough to make markets safer. International efforts should be based on principles rather than stipulated rules. The issue of resolution of failing financial institutions is central – taxpayers cannot again underwrite the financial sector. Global crisis management will be difficult unless there are more modular and simpler structures in the banking sector. There should be a level playing field to prevent regulatory arbitrage – sustainable business cannot be structured based on locating operations where rules are weakest. Although the newly created ESAs are working well, some note co-ordination could be improved.



David Wright
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The current interconnection of asset price inflation, and the need for growth and macro-prudential stability presents a huge opportunity for the EU to demonstrate global leadership. Trust between consumers, government and financial service providers must be revived. Market participants need to educate investors, in part through providing simple products and clear communication.

3. The chair, **David Wright**, recently Deputy Director General of DG Internal Market and Services in the European Commission, set the scene noting the Eurozone crisis is arguably more dangerous than the situation after the collapse of Lehman Brothers in 2008. The resources of the **European Financial Stability Facility** (EFSF) are insufficient to combat sovereign debt in the Eurozone – some liken it to a pumpkin without a middle. With considerable macro- and micro-economic uncertainty coinciding, the time is becoming shorter to agree a safer financial system and the rules which govern it. What regulation is and is not needed? If the Bank resolution issue is not resolved, can it be said there is any real progress?

The European Single Market in financial services

4. For many EU governments and commentators, both inside and outside the Eurozone, more co-ordinated economic and fiscal governance in the Eurozone is the only solution to the Eurozone crisis. The EU has adopted the G20 financial regulation agenda. The body of EU legislative work is not a bureaucratic concoction. The vision of a single market in financial services was based on the principles of minimum harmonisation and mutual recognition to bring about financial market integration, a pan-European level playing field and convergence in supervisory practices. While financial market integration has progressed and large cross-order groups have become dominant players, the regulatory and supervisory structure has lagged behind. Financial regulation has been harmonised through EU directives, but national rulebooks under the same directive can vary enormously. This has serious drawbacks for the stability of the EU financial



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system, and has resulted in some regulatory competition to attract business or support national champions. Thus integrated EU wide supervision at the group-wide level and management of cross-border groups has become more difficult. Accordingly the European System of Financial Supervisors (ESFS) tasks the EBA and the other two ESAs to restore stability and governance of financial institutions through the drafting of technical standards, that once endorsed by the Commission, become legally binding across the EU.

5. The financial services industry is being confronted with a torrent of new and proposed regulation and reports such as **Solvency II**, the **International Regulatory Framework for Banking** (Basel III), **Dodd Frank**, **Vickers** etc. There is a clear EU timetable and process to drive regulation forward (see annex). The three new ESAs are largely working well although some note a tendency for them to work in silos. Key efforts are being made to bring capital requirements in line with Basel III (through the Capital Requirements Directive (CRD) IV), Solvency II (due to be implemented in 2013), and on Credit Rating Agencies (CRAs) II. Other legislation being proposed includes work on Over-the-Counter (OTC) derivatives (a €6 trillion a year market), Markets in Financial Instruments Directive (MIFID) II, High Frequency Trading, and crisis resolution.

6. The EU Commission wants to remove the potential scope for conflicts of interest involved in CRAs and audit, and wants to look more closely at sovereign ratings (under an international solidarity programme). The International Monetary Fund (IMF) has a role here and audit has to apply the same transparency. Directives on audit and CRAs were well received in the UK. However, UK Prime Minister Cameron is critical of attempts to further regulate the City of London. The German and French governments support a Financial Transaction Tax (FTT), which would have a disproportionately adverse impact on the City of London, as well as impact the wider economy. Yet the FTT does nothing to address systemic risk and would ultimately be paid by end users such as pension funds. It is almost certain the FTT will not be implemented on a pan-EU basis, although it may be progressed by Eurozone member states.



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7. Some argue the UK has not been “hectoring” other EU member states but trying to persuade them to avoid the unpleasant UK experience of crisis structural adjustment in the 1970s and 1980s. The allegation that financial services are being

promoted in Paris and Frankfurt at the expense of the City of London is strongly refuted. The City of London is a tremendous asset to the EU, and it in particular has benefited from the Single Market. The presentation of Commission proposals in some key member states could be improved if they were published soon after proposals in key affected member states, for example, after a government commission or committee report.

What are the principles of sound regulation?

8. The financial crisis exposed fundamental weaknesses in the global financial system and the need for policymakers and regulators to take steps to make the system safer. The crisis creates a huge opportunity for the EU to lead the world. There are possible reforms to the structure of financial sector which can make it more resilient to crises in future. There is support for more discretionary risk based regulation, macro-prudential regulation, internal separation within universal banks and higher capital requirements. It is important that regulators, central bankers and market participants alike understand how legislation may work in practice, and whether this will deliver the originally envisaged principles and objectives. Legislation and regulation needs to be “back tested” to assess its impact and appropriateness. Principles should guide the direction of regulation. Should regulation diverge from these principles, regular joint assessments should be made to ensure a level playing field.
9. Market participants accept the need for appropriate regulation, and many may regard the following as principles of sound regulation. Firstly, institutions, employees and shareholders should be incentivised to behave in a way that is conducive to effective markets and financial stability. It is a misalignment of incentives for the risks from banking to be spread amongst taxpayers and the public, but the returns be retained by bankers. On the whole, significant progress has been made towards aligning incentives in particular through deferred compensation schemes, and CRD IV has many benefits. However, it remains the case that employees are paid in equity rather than debt. As shareholders own options sold by creditors and option owners are incentivised to increase risk, incentives would be better aligned if employees were paid in subordinated debt.
10. Secondly, the taxpayer should have seniority over all other claims and creditors. Socialising losses and privatising profit is iniquitous. Private sector banks should not be “too big to fail” and taxpayers should not be required to support them. The UK’s Independent Commission on Banking (Vickers Commission) notes in its final report that bank failure tends to be interconnected and the collateral damage is widespread, ultimately affecting broader economic growth. For this reason, governments have often felt obliged to provide support for failing banks, particularly those considered systemically important. Market recognition of this fact contributed in no small measure to the financial crisis as creditors (rightly) believed their risk was being underwritten by governments, thus removing a crucial element of risk control from the banking system

(in the run up to the financial crisis, some European banks were 50 to 100 times levered). This is undesirable because it creates moral hazard (uninsured creditors believing ex-ante that a bank is “too-big-to-fail”, and therefore provide funds at artificially low rates, with no incentive to impose market discipline), distorts competition in the marketplace, increases the risk that taxpayers are required to support failing banks and affects economic activity, often for many years. Reform should focus on credible creditor bail-in (the possibility for the competent authorities to impose the write-down or the conversion into equity of uninsured and unsecured liabilities when specific targets are hit). If creditors know they will be forced to take a haircut when a bank enters resolution, they are far more likely to constrain risk than encourage it. It is hoped that the European Commission’s forthcoming proposals on Crisis Management will mark a significant step in this direction.

11. Bail-in now appears to be broadly accepted, though it is unclear whether some jurisdictions, notably Japan and possibly France, support the principle. Moreover, policymakers may find it politically unpalatable to abide by this principle. In a world without government subsidy, if banks’ weighted average cost of capital becomes too high, it will ration the availability, and increase the cost of credit to borrowers. In these circumstances, will governments desist from extending their guarantee? Furthermore, market developments may have a negative impact on the position of the taxpayer. For example, the growth of the covered bond market is resulting in the structural subordination of depositors and by implication taxpayer claims.
12. Thirdly, economic and regulatory capital signals should be aligned. Many of the mistakes in the run up to the financial crisis stemmed from obtuse regulatory capital requirements which did not align with economic capital, for example, zero risk weights for 364 day revolving credit facilities, and zero risk weights for government bonds. Now the opposite problem, where regulatory capital arguably overstates risk to the consequent detriment of the economy, appears the likely result of the proposed risk weighting of Asset Backed Securities under the Solvency II directive.
13. Fourthly, regulatory arbitrage, made possible by the lifting of capital controls, should be avoided at all costs. Avoiding regulatory arbitrage would require unprecedented global agreement. Nevertheless, some argue the laudable search for consistency is too late and it is better to have rules in place as arbitrage is what makes markets work. In practice, regulators and market participants pay lip service to the need for global coordination and consistent implementation. Policymakers and regulators therefore need to minimise, as far as possible, the potential for arbitrage between jurisdictions. One key area of concern is the treatment of risk weighted assets in the calculation of capital requirements. There has rightly been much focus on the numerator (namely the equity capital held by banks). However, much more focus on the denominator (the estimation of risk weighted assets) is needed in order to ensure international comparability. Some

suggest a fifth principle (proportionality) should be added, given many believe the effort to comply with legislation is not commensurate with the expected benefits.

Banking Regulation

1. The **Vickers Commission** aimed to avoid any further taxpayer liability to the financial system, promote financial stability and competition, and identify the fiscal system and risks to it. It advocated ring fencing within banks to insulate retail banking operations from potential losses in investment banking. More modular structures are also necessary for resolution. The emerging resolution regime seeks to address the moral hazard issue, but increasing agglomeration and higher barriers to entry render the “too big to fail” problem greater than ever. Some argue global resolution is unlikely unless the more modular structures (eg ring fencing) that Vickers proposed is introduced more widely. Others argue that if modularity is taken too far, this is self-defeating for financial stability, and so ring fencing may be best applied flexibly.
2. The EU context was important for the Vickers Commission given the plethora of EU regulatory initiatives. Some of the Commission’s recommendations were framed to be compliant and dovetail with EU law. There are risks of policy intention being undermined by regulatory arbitrage. Yet uniformity for uniformity’s sake is unwise, and there is widespread agreement that maximum harmonisation within the EU would be the wrong way to proceed. However, minimum harmonisation is not enough as this is effectively the current environment.
3. The implementation of **Basel III** in the EU provides a real opportunity for realising the single rulebook. The Commission’s **Capital Requirements Regulation** (CRR)/CRD IV proposal requires 40 technical standards to be drafted by the EBA including a uniform definition of capital across the EU in line with Basel III’s quality criteria;



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implementation of Basel III provisions on liquidity on the basis of an “observation period”, and uniform reporting and compensation rules. The CRR/CRD IV proposal implements the Basel III liquidity provisions, whilst allowing for flexibility regarding the calibration of ratios, envisaged by the 2015 liquidity coverage ratio (LCR) and 2018 for the net stable funding ratio (NSFR). It is not clear when or how different jurisdictions will implement Basel III (or whether some will implement it at all). Risk weighted asset calculations need to be harmonised as without it the temptation will remain for banks to game the system. An objective test of risk weighted assets is needed.

4. Banks need to set aside sufficient high quality liquid assets to withstand periods of stress, and constraints need to be set for their engagement in maturity transformation. The financial crisis demonstrates that macro-economic imbalances may well affect stability and the institutional link between macro-economic factors and timely micro-prudential regulation and supervision. The need for specific capital buffers and liquidity ratios to cater for the macro-prudential dimension was confirmed when Basel III was endorsed by G20 leaders in Seoul in November 2010. It is nevertheless essential that national discretion is constrained and exercised within a European framework. The ERSB should develop an ex ante framework for the exercise of discretion and check ex post compliance with these principles. Such “constrained discretion” is embodied in the first macro-prudential instrument agreed upon by the Basel Committee.
5. The new regulatory framework provides an opportunity to promote convergence in supervisory practices. The EBA’s work can be crucial in facilitating consistency across countries regarding processes, supervisory outcomes and methodologies followed in “supervisory review and evaluation processes” carried out by national supervisory authorities under the Basel framework (“Pillar 2”).

The EBA can address discrepancies through peer review mechanisms, issuing binding technical standards, issuing guidelines, working in colleges and mediation in case of disagreement between national supervisors within supervisory colleges.

Bank resolution

6. The **Financial Stability Board** (FSB) recently proposed recommendations to: strengthen national resolution regimes with the same range of resolution powers and tools; cross-border co-operation in the form of bilateral or multilateral institution-specific co-operation allowing for greater integrated resolution of cross-border entities, and improved resolution planning by firms with recovery and resolution plans (RRPs). Three features are judged central to future efforts: RRP and resolvability of cross-border groups; implementing resolution on a cross-border basis and financing of group-wide resolution schemes, and bail-in.

7. Exit and orderly resolution needs to be a credible option for Systemically Important Financial Institutions (SIFIs) in particular. The financial system will not be secure so long as implicit government support for systematically important institutions remains prominent. Failures may result from adverse developments in only one area of the business which, due to high leveraging, may result in the bank being insolvent despite the great majority of its areas of business being fundamentally sound. Firms should be aware of their structures and potential vulnerabilities, and home and sometimes host authorities (in the case of cross-border groups) should be able to implement rapidly resolution tools. Resolvability assessment should not lead to segmentation across national and business lines which may jeopardise enhanced firm-wide management of risks. There needs to be progress on the right institutional incentives to spur national authorities to converge towards coordinated actions, and pool national resources on a cross-border basis. There needs to be equitable treatment of all stakeholders across all jurisdictions. Having the same resolution toolkit in each jurisdiction is a first step. The EBA could design binding technical standards to help avoid such unintended consequences such as fragmentation and



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ring-fencing of cross border groups, and could mediate in case of disagreement. A legal framework for intra-group financial support should be implemented.

8. Rescue operations are not solely a matter of national budgets as this prevents integrated resolution. A step forward would be the establishment of a European System of Resolution Funds (ESRF) financed, ex ante, through contributions of cross-border groups. This could break the link between sovereigns and banks. The fund should be built up gradually and to allow supervisory convergence and cooperation.
9. Bail-in needs to be properly drafted in EU legislation, and the EBA could help design a level playing field. Bail-in requires mutual recognition of some aspects such as the identification of the authority (whether home or host) triggering it, the type of shares to be issued in case of conversion, and which issuers would be affected. From an ex ante perspective, bail-in restores debt market discipline, making creditors contribute to the bank's recovery and curbing moral hazard, and the implicit subsidy that SIFIs enjoy. Once failure occurs, bail-in reduces the probability of public intervention and its fiscal impact, and thus the probability of default. The overarching principle would be that bail-in can be activated only if creditors are not "worse off" than they would be if the bank were ordinarily liquidated. Identification of large bail-in liabilities would give competent authorities the discretion to calibrate bail-in to the actual amount of capital required to restore viability of the bank involved. As this could jeopardise creditors' ability to value appropriately the nature and extent of risks and exposures, provoke systemic contagion or result in a bank run, bail-in could exacerbate the current volatility in financial markets, and therefore it is recommended that any related provisions are not brought into force until 2015.
10. One of a number of possible options for ensuring orderly resolution are bail-in bonds. This form of lending, by being converted to equity when the borrower faces insolvency, would potentially allow troubled banks to weather losses in particular areas of their business without the need for public support. The areas of their business that were still viable could therefore be preserved, either under original or new ownership. Furthermore the cost of this support would fall on the bond holders, creating an incentive for stronger oversight by lenders and better risk management by borrowers in order to keep down lending costs. Corporate bond holders in most sectors accept the risk of possible insolvency. The price of borrowing could reflect the increased risk. If the measures did produce greater financial stability, the existence of such a market would benefit bond holders by decreasing the risk to the real economy and so to their other bond holdings.
11. The impact of new rules on the shape of the banking industry is uncertain. There is however likely to be less room for regulatory arbitrage. Since the Banco Ambrosiano scandal, the aim has been to integrate bank risk management and have more of a firm-wide approach. Markets will increasingly operate nationally rather than globally – this is

different from there being global banks. A smaller number of utility banks operating in retail is likely. The European challenge is to compete in critical mass with China. EU payment and credit “factories” might be usefully created.



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Insurance and pensions: the impact of risk based supervision

12. Insurance does not have the liquidity risks of the banking sector, and has acted as a stabilising force during the crisis as it matched its long term liabilities with long term investments.
13. The current Occupational Pension Funds Directive (IORP I) involves minimal harmonisation. The changing regulatory framework, moving towards risk-based supervision, will likely add another layer of complexity to the management of pension funds. It is too early to forecast whether IORP II might succeed in bringing more harmonisation across the European pension landscape. It will still take several years before the Level 2 implementing measures revising the existing pension fund directive will be known.
14. After the financial crisis, there has been a need for risk-based supervision and supervisory consistency across pension and insurance funds. The supervisory system should consist of quantitative elements but also cover qualitative aspects (covering features such as managerial capacity, internal risk control and risk monitoring processes etc.) The European Commission proposes that the new supervisory system for pension funds be based on the three pillars that are the same as those in the Solvency II directive: quantitative requirements, qualitative rules and transparency requirements. However, the impact of IORP II will not be the same across the EU because some member states apply already risk-based supervision (such as the Netherlands, UK and Nordic countries) while others don't (Italy, Spain).
15. The Level 2 implementing measures of the revised IORP II directive are not yet known. There will

probably be four main impacts for pension funds from the risk-based supervisory regime: increased volatility of the balance sheet of defined benefit schemes (the challenge will be to de-risk the balance sheet of un-rewarded risks); lower funding levels of defined benefit schemes (the challenge to maintain adequate funding levels); necessity to constitute regulatory own funds (solvency margin) for defined benefit schemes (the challenge will be to protect/maintain the capital that covers regulatory own funds); and life-cycle investment strategies for the “default option of defined contribution schemes” (the challenge will be to develop enhanced life-cycle investment strategies that provide individual investors with adapted solutions to their long-term retirement savings needs).

16. The positive impacts of risk based supervision include: market based valuation of asset and liabilities affording a more accurate reflection of financial position, and well needed discipline; and insurance companies will also explicitly consider capital charges in deciding which products to offer clients. If a promise is made with respect to provision to protect the individual (pension fund participant or policyholder), risk based buffers are required to reduce/eliminate the probability of underfunding.

17. Among the unintended costs of risk based supervision are a clear risk that regulated entities become preoccupied with making sure the regulatory constraints are being met. In some cases this leads them to lose other (even more important) goals. For example, Dutch pension funds are concerned about their short term nominal solvency ratio. Unfortunately this target is not compatible with pension funds’ true long term objective, namely to pay out pensions that are indexed to prices or wages. Secondly, short term regulatory constraints (minimum solvency ratios) can be incompatible with longer term ambitions. Risk based regulation can give rise to pro-cyclical behaviour. During times of market distress when reserves are under pressure risk will have to be reduced while risk can be increased when reserves are well above their minimum levels. This may mean selling risky assets or hedging risk at the bottom of the market or when it is most expensive. These effects can be magnified when these actions are carried out by many at the same time. Risk regulation can therefore lead to herd behaviour. For example, the effect of hedging on the Euro swap curve may become more pronounced when insurance companies enter the market to hedge their asset liability mismatches ahead of 2013/4 when Solvency II is introduced. Thirdly, current risk based regulation means that the risk appetite of traditional long term investors decreases. The preliminary effects of the introduction of Solvency II on insurers’ asset allocation include less exposure to equities and alternatives; a reduction of the duration of investment in corporate credit, and more demand for government bonds. This raises the question of who will fill in the gap in risk capital provision.

Solvency II

18. The Solvency II directive aims to make insurers manage their own risks properly and to provide consolidated protection through better alignment and reducing risk. Market consistent valuation of assets is a fundamental element. Higher capital levels are not the solution for all risks. Own Risk and Solvency Assessment (ORSA), a bottom up process, is fundamental to Solvency II. It was not conceptualised with the pretext of dramatically increasing insurers' capital level. Solvency II should however incentivise appropriate risk taking and not determine unnecessary levels of prudence that do not achieve consumer objectives and inhibit consumers' ability to save.
19. The insurance industry has been a supporter of the Solvency II project throughout. However, both regulators and market participants need to understand fully the consequences of Solvency II particularly in light of the crisis and not rush to conclusions that undermine the benefits for customers, the industry and the wider economy. There are unintended consequences of Solvency II including changes in investment policy from long to short bonds. In the past 10 years, change has been due to new risk management policies. Insurers have difficulty in investing in sovereign bonds due to new perception of risk. Secondly, increased consolidation is likely although it will not be drastic. Pro-cyclicality will be needed to promote market stabilisation whereas capital requirements have been anti-cyclical.
20. Solvency levels have hitherto been driven by assets which were valued at book value. This has meant solvency positions have been relatively static which reflects the long term nature of insurance and its liabilities, although not always capturing the risks. Solvency II moves the industry to a total balance sheet approach based on a realistic, market consistent assessment of the value of assets and liabilities. From a risk management perspective, this incentivises companies to identify, assess and manage the risks to the

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balance sheet, encouraging adequate capital to be held to cover these risks.

21. As the Solvency II regime is still developing, there is still material uncertainty and challenges which have been magnified by the ongoing market volatility and the sovereign debt crisis. The application of Solvency II is effectively being stress tested by these conditions. The framework of Solvency II aims to encourage insurers to manage effectively the risks assumed, with appropriate capital being held to cover these risks. The Prudent Person principle enables insurers to identify, monitor, manage and mitigate the risks associated with different assets. Insurers are not necessarily exposed to immediate market pressures as a result.
22. If there is to be recovery from the current crisis, there must be a focus on long term sustainable investment in economies, whether investment in sovereign debt, corporate debt or long term projects such as infrastructure. As the insurance industry is a critical investor in public initiatives and long dated funding to the real economy (investments that correspond to insurers' liabilities), insurers have to be careful to ensure regulation does not penalise or provide disincentives through onerous capital charges that inhibit insurers from investment. It is also important that Solvency II does not drive the whole industry to invest in short term ("risk free") investments as this would only create new interest rate risk. Insurers need to continue making long term investments. Limiting the sources of capital for corporates at the juncture in the economic cycle would be counter-productive. For example, within the UK corporate bond market, 41% of bonds issued with 25-35 year maturities are rated BBB. Proposed restrictions on BBB and lower rated assets would be detrimental to UK corporates, at a time when the ability to raise capital is constrained in any event. Given that the equity market is effectively closed, the bond markets are the only source of funding open to many of these corporates. Closing off one avenue of funding (from insurers) seems to be counter to everything else that is trying to be done to help revive ailing EU economies. Insurers need certainty to react and maintain their stabilising influence in a crisis. Accordingly, counter-cyclical measures need to be incorporated into Solvency II together with predictability (a formula) on how and when these measures will apply.
23. Without this certainty, insurers will reduce their exposure to long dated instruments and companies will not take interest rate risk. Instead they will look into ways to reduce their volatility through shorter dated instruments. It is difficult to see how insurers, particularly life insurers, will be able to attract funding without reducing the volatility of the balance sheet. The paradox of Solvency II could be to create a long term industry that is managed through a short term solvency lens with less diverse asset pools. Rather than cementing insurers' role as stabilising forces, this risks creating greater volatility and instability due to substantial re-financing risk being introduced.
24. The rules as they are being developed could have far-reaching unintended consequences for end customers in the form of lower returns on savings and pensions. Guarantees

given to the consumer are expensive, and mean that return on investment will be less. The problem is not risk based supervision itself (which is simply the kind of supervision required to deal with guarantees), but the current promises associated with retirement savings. To provide a good pension, one needs to move away from hard guarantees. For pension funds, this means a move to 'new' pension schemes away from Defined Benefit to Defined Contribution plans. These developments have real macro-economic impacts, and big commercial impacts which could present real political problems, a fact recognised by the European Commission. Tangible solutions including the Matching Premium, Counter-Cyclical Premium and extrapolation have yet to find their way into the level 2 text, and there continues to be no clarity or certainty on how profit profiles and dynamics of products will be affected.

25. The industry and regulators are close to resolving these issues which by one estimate is the most critical 5% still to be resolved (though some note matching decisions are extraordinarily important so progress is hard to quantify). The tools and solutions, including counter-cyclical mechanisms, to address the last 5% are known. Now is a time to make these work, learn how they will apply, and to consider and understand their implications. The time left before legislation is finalised should be used to make sure that Solvency II works and has appropriate and effective counter-cyclical measures built in. There should not be a rush in the last 12 months. Given awareness of a number of issues, market participants and regulators should be open and honest and test how they apply. If this requires a longer period of introduction, the industry should not shy away from this.
26. The implications of new regulation and market developments for insurance companies are higher capital charges associated with traditional with profits products that offer guarantees; and a move towards products featuring more risk being transferred to its policyholders and third party asset managers (unit-linked products). There will probably still remain a market for products that contain guarantees but only for clients who are willing to pay a higher price.

Securities regulation

27. The financial crisis was not a crisis of securities regulation as was, for example, the dot com crisis.
28. There is a move from a rules-based product environment in securities regulation to a more risk and rules based system. There is a considerable body of directives targeting only asset managers including Undertakings for Collective Investments in Transferable Securities (UCITS) 4 and 5, Alternative Investment Fund Managers (AIFM), MIFID, short selling, and Solvency II (see annex).



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29. ESMA is a diversified organisation and has a wider range of tasks than EBA and EIOPA. ESMA is regulating financial institutions but not supervising them directly. Its role is however potentially greater given some believe the International Organisation of Securities Commissions (IOSCO) is behind the curve as it doesn't shape standards like the Basel Committee.

30. There appear to be a number of priorities for ESMA:

a. CRAs: many find it astonishing that CRAs were unregulated until the financial crisis. ESMA registered larger CRAs in early November. The process was long as it involved a college system and meeting criteria, improving control and conflict issues and a fundamental change in CRAs. Inspections will be first conducted and the second priority is a single rule book with written standards on CRAs and rolling technical standards in the European Market Infrastructure Regulation (EMIR) and MIFID II. The G20 aimed to bring derivatives under its purview, and will have to set technical standards for central counterparties and determine which contracts have to be centrally cleared. If the drafting of technical standards is to be of a high standard, a full year is needed during which time a cost-benefit analysis should be conducted.

b. Creating the Single financial market can create greater consistency across sectors. Governance issues are high on ESMA's agenda. If there are conflicting rules, this undermines the credibility of supervisors. More transparency requirements such as observing and monitoring can be notified to national authorities and thence to ESMA. If the same regulation applied differently within the EU, then firms can appeal to

ESMA which can mediate. For example, when a product has a local importance and minimal salience in other jurisdictions, a national ban should be implemented only after consultation with the 26 other authorities (on grounds that one nation may be seriously affected). Mutual recognition in securities is the way forward to measure equivalence in Asia and the US.

- c. Investor protection requires a paradigm shift. The current levels of protection are better in investment products than insurance. Transparency is needed but alone is not enough. Alternatives to transparency include duty of care, product approval, bans on inducements and products. It is uncertain where the responsibility of the regulator stops and service provider starts. Complex products should be banned for retail investors.
 - d. Stability is new to securities regulators and is the operational part of the European Systemic Risk Board (ESRB). Synthetic total return swaps alter products. There is concern on logarithms involved in high frequency trading. These introduce complexity which does not lend itself well to self-regulation.
 - e. The diversity of accounting systems is a concern. Some do not see why treatment should be similar. Financial requirements are important to determine profits and this has a bearing on the health of the organisation and cash retained within it. It is important to have the accounting right, and the aim is to have consistent reporting by the end of 2011. There is a disconnect between financial reporting and International Financial Reporting Standards (IFRS) market value due to the mixed accounting model. The incurred loss model still has original values in statements.
 - f. a sixth priority might be crisis management, for example short selling bans.
31. From an industry perspective, the G20 agenda is driven more by politics than actual need, and this can encourage short-termism. Too much time has been spent on CRAs, and there is too much “emotion” on Exchange-Traded Funds (ETFs) and stock collateral. A proper impact assessment is needed. For example, why examine MIFID II when MIFID I is not fully implanted in national jurisdictions? Regulators should look at financial markets and financial products as a whole with a level playing field approach. MIFID aims to establish a sound transparent system that is attractive to consumers but it may end up limiting consumer choice, reduce competition and increase price for



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consumers. Once level I and II rules are set, they will be implemented only slowly. More harmonisation is needed in the securities pillar, and a common supervisory culture is at least as important as common standards. Complexity is an additional risk. The authorities can't regulate every single step of the selling process which involves disparate facets including transparency, advice, professional qualifications, and distribution.

32. Consumers cannot have products that are risk free but products should be readily understood. Transparency is not enough. There are means to regain consumer confidence: encourage real risk assessment in financial system; apply a proper price; promote proper business conduct (avoid conflicts of interest in CRAs and intermediation); increase transparency towards market and consumer; provide comparable information, and reinforce preventative risk based supervision (ie saying no when times are good and when bubbles are developing).
33. Of the € 40 trillion managed worldwide, a third is in the EU. Although Asia Pacific investors are investing in property rather than funds, and the asset management industry is suffering. UCITS are a universally recognised brand comprising 80% of funds managed in the Asia Pacific. With Yuan/Renminbi products becoming more important within the region, the challenge is to ensure UCITS remain attractive to investors. There is growing scepticism about the relevance and pricing transparency of UCITS, notably on products with an insurance wrapper. EFAMA and the EU Commission are aware they must involve Asian regulators in discussions on new UCITS regulation, and that regulators in the region have to be comfortable with the product,

Retirement provision

34. Regulation is taking place within an environment of changing demographics, government austerity, and forecast prolonged low growth. If developed economies don't grow, their governments and citizens will face a serious pensions crisis. People are not rushing to save. The emphasis of regulation is on protection, but there might be a role for encouraging savings. The disjuncture between short term politics and the longer time horizon of many money managers exacerbates the problem.
35. People are living much longer, with many in the future enjoying retirements that will span several decades. With the fiscal challenges facing most governments, customers are being told they need to take greater ownership of their financial futures and to save for their retirement. An Aviva 2010 report, 'Mind the Gap', identifies a €1.9 trillion annual pensions gap (based on investment



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returns of 5%) between what European citizens require in retirement to enjoy an adequate standard of living, and the amount they are projected to receive.

36. Americans have become more, not less dependent on pensions. The main retirement savings schemes in the US, defined benefit and defined contribution plans, are designed to provide only a portion of retirement income. The balance between US Social Security and private pension has been stable over time with Social Security remaining the primary source of retirement income for many retirees. The large group in the middle have some savings but their pension planning requires thoughtful public/private synergies: government is already the provider of last resort; ideally new solutions fill gaps via private savings; and governments incentivising savings via tax policy. The lower Income group will not achieve security via private savings, and will rely on government, family and working longer. Investment products per se will not help them because savings are low.
37. There are many common challenges getting people saving for retirement; getting people to save enough; getting people invested appropriately for their circumstances; determining when to retire and when to start drawing down retirement savings; and managing retirement income and drawn down approaches. While solutions vary by country, many developed countries are attempting to address the same challenges: ageing populations, insufficient personal savings, broke public pensions, and lack of financial literacy. Most investors do not want to be financial experts. Removing the need to make a fund selection could be the most appropriate route. For most investors, set and forget is the preferred option.
38. Auto enrolment in the US has increased pension participation rates, turns many non-savers into savers which helps increase the overall average savings rate of all eligible employees. However, the contribution

rate of 5.2% is still too small to provide for an adequate retirement. UK NEST accounts tackle the savings rate issue with an 8% contribution rate (3% employer, 4% individual and 1% tax relief). In other parts of the world, participation is handled with mandatory plans such as Australia Super, Singapore CPF, Malaysia EPF and Hong Kong MPF.

39. Insufficient saved funds for retirement is a common problem, and many Americans expect to solve this problem by working longer. However, of current retirees, 45% left the workforce earlier than planned (80% were due to their own or a family member's health). Earning a wage in retirement may not be a viable solution even though 74% of today's workers plan to work during retirement (only 23% of today's retirees actually do work).
40. Part of the challenge of when to retire and how to manage the assets is that no one knows how long we need to make this pool of savings last. With annuities, the pooled risk of the group solves this problem. With individually controlled defined contribution plan assets, each individual has to guess how long they will live and therefore how long their assets need to last. Yet many underestimate how long they will live. Many people will have retirements lasting more than 30 years. An adequate retirement income therefore needs a combination of public and private savings. Providers should keep their message simple and products user friendly, and emphasise people must start saving when they are young as working longer may no longer be an option.



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Regulatory convergence between the EU and US

41. At the outset of the 2007-8 financial crisis, US politicians tried to take back the initiative, pointing to regulatory and supervisory failure as the root cause of the crisis. However, the level of technical knowledge and detail required and need for politicians to keep an eye on their re-election meant that Dodd-Frank left drafting of the details and implementation to regulators.
42. The US regulatory structure, and the Dodd-Frank Bill in particular, is the legacy of political interests, infighting and patronage. Today current budgetary political wrangling risks neutralising the ability of the existing agencies to implement Dodd-Frank. The lack of funding for the SEC has much to do with why there was never a single examination by the Securities and Exchange Commission (SEC) of any of the five investment banks, notably Bear Stearns and Lehman

Brothers, for which it had consolidated supervisory authority prior to the financial crisis.

43. The rapprochement between the SEC and the EU, notably under McCreevy and Cox on convergence and mutual recognition, seemed to break down for a variety of reasons after the financial crisis, partly because the Obama appointees didn't yet know their EU counterparts, and partly because it looked too much like agencies were acting on behalf of the banks. On many levels, convergence between the EU and US regulation appears unlikely in the future. The aim might more appropriately be to arrive at a common toolkit, rather than consistent legal treatment. Addressing cross border crisis resolution is far more important for systemic stability than OTC derivative convergence. Nevertheless, the EU and US have been doing their best to harmonise efforts, and according to one estimate, there is close EU-US co-operation on 80% of transatlantic regulation. The SEC, ESMA and the Commission have been meeting at least once a week since August 2011 to try to reach an agreement on key aspects of derivatives regulation. The slippage on rulemaking in Title VII of Dodd-Frank was in this case intentional, as it made no sense to write the rules on cross-border issues until such discussions had been convened. The SEC plans a concept release towards the end of 2011 although the EU process has slightly less latitude, and legislation has been delayed to ensure discussions with the US and other key third countries. Regardless of the creation of ESAs, the SEC and Commodity Futures Trading Commission (CFTC) will need to work directly with EU national supervisors on many issues. The only ESA level work is effectively the supervision of CRAs as that is the one place where ESMA and the SEC have similar levels of authority. Rules and law will need be discussed at the EU level, but conversations about the supervision of an entity or enforcement actions will rely on co-operation at the national supervisory level. Although transatlantic cooperation is good, there is still no resolution.
44. There are too many players and it is uncertain who should lead. After a crisis, there is a natural tendency for national self-interest to come to the fore. It is hoped that some flexibility, experimentation and iteration in international co-operation will help limit the unintended consequences of regulation and the likelihood of systemic failure in term of all regulators getting the same thing wrong at the same time. Nothing will break the regulatory log jam between the EU and US, not even mutual recognition. International standard setting is not going to happen. The UK needs to be at the heart of any transatlantic regulatory co-operation. A lot of time is being spent on trade depositories and Central Counterparty (CCPs), and there is concern there is no central co-ordinating body. Others see EU-US regulatory co-operation in a more positive light given there has been no major breakdown and capital flows freely, and regulatory arbitrage is largely dismissed.

How High Growth Economies in India and Brazil navigated the financial crisis

45. Whilst OECD economies face a prolonged period of low growth, key drivers of growth in leading emerging economies include a high proportion of young people, a high savings rate, low welfare state costs, labour market flexibility, and cautious but steady liberalisation of markets.
46. In the case of India, among the many measures undertaken to counter the crisis, there was no inflation targeting (financial stability was not an acknowledged formal objective although it is part of the background). There was a strong liquidity regime. Trade repositories and CCPs were controlled with considerable emphasis on transparency and risk mitigation in OTC transactions. The Reserve Bank of India (RBI) pursued countercyclical variations in capital and provisioning measures. There was good coordination between monetary and macro-prudential policies. The prudential framework involves sound counter-cyclical measures, exposure norms and liquidity management, and aims to increase the resilience of the banking system with instruments such as time varying risk weights, and provisioning norms of standard assets in some identified sectors. Prudential limits helped ensure the non-disruptive functioning of the inter-bank market through limiting the inter-connectedness of banks; limits on aggregate inter-bank liabilities as a proportion of their net worth; limits on cross-holdings; restriction of access to un-collateralised funding market (only banks and primary dealers are permitted); caps on both lending as well as borrowing; containing regulatory arbitrage; capping banks' investment in liquid schemes of Debt-oriented Mutual Funds to limit circular flow of funds between banks and mutual funds. Common exposures to capital market were subject to a supervisory limit of 40% of net worth of the bank, and bank exposure to sensitive sectors such as real estate.



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47. Only banks and primary dealers were allowed access to uncollateralised funding. There were restrictions on exposure to complex activities and products. India had little exposure to sub-prime assets and stressed assets, functional financial markets, and well capitalised banks. Wide ranging safeguards were put in place. Additional capital requirements were introduced where reputational risk was high. There were stringent criteria for securitisation transactions. India kept domestic money and credit markets functioning normally through maintaining comfortable liquidity position, augmenting foreign exchange liquidity, and ensuring adequate supply of credit; reduction in policy rates; infusion of rupee liquidity; infusion of foreign currency liquidity; counter-cyclical measures (relaxation of risk weights and provisioning requirements). The government undertook fiscal stimulus amounting to 3% of GDP (through additional public spending, particularly capital expenditure; government guaranteed funds for infrastructure spending; cuts in indirect taxes; expanded guarantee cover for credit to small enterprises, and additional support to exporters. Despite these measures there was no expansion of collateral accepted by the Central Bank; entire execution was through banking channels, and no increase in deposit insurance.

48. The Brazilian economy suffered from the 2008 crisis due to instability in the exchange market and low liquidity. A conjunction of macroeconomic, historic, structural and regulatory factors enabled a timely policy response. Lessons had been learned from previous crises and a robust infrastructure and regulatory framework built in previous years. Since the 1990s, economic stability has been established through inflation targeting and tough fiscal measures, with a reduction of the government's foreign exchange exposure. Among structural and regulatory factors were: strong governance and transparency requirements of the Investment Funds Industry; stricter Basel Rules and the Central Bank's

consolidated supervision, accounting for a sound and solid financial system; robust depository and settlement infrastructure (including a sophisticated Payment System), mandatory registry for all OTC transactions (including derivatives) and segregation of participants' accounts and records; reserve requirements and Deposit Guarantee Fund mechanisms. During the crisis, hedge and monetary instruments for avoiding liquidity pressures were available, and strong regulatory and self-regulatory controls were important to explain the low leverage in the financial system and the absence of securitisation or shadow banking instruments' misuse. GDP growth of over 3% a year is forecast for 2011/2012, and a programme to build a long term capital market for infrastructure and investment funding is underway.

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November 2011

- *This report is a brief summary of the main points discussed at the Cumberland Lodge conference. The report reflects the rapporteur's personal interpretation of the proceedings - as such it does not constitute any institutional policy of the European Financial Forum or the conference co-sponsors, nor does it necessarily represent the views of the rapporteur.*

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Annex

Annexed is a table of reforms adopted or proposed in the European Union in response to the financial crisis and G20 commitments circulated by **Commissioner Michel Barnier**.

FINANCIAL REGULATION PROGRAMME OF THE EUROPEAN COMMISSION IN RESPONSE TO FINANCIAL CRISIS AND TO G20 COMMITMENTS

REFORMS PROPOSED BY THE EUROPEAN COMMISSION, ADOPTED & IN THE PROCESS OF BEING ADOPTED BY THE EUROPEAN PARLIAMENT AND THE COUNCIL OF MINISTERS

AGENDA	
Proposals adopted by the European Union	
Commission proposals being discussed in the Parliament and the Council	
Upcoming Commission proposals	
+ G20 proposals	

REFORMS PROPOSED BY THE EUROPEAN COMMISSION, ADOPTED & IN THE PROCESS OF BEING ADOPTED BY THE EUROPEAN PARLIAMENT AND THE COUNCIL OF MINISTERS			
	BANKS AND INSURANCE UNDERTAKINGS	FINANCIAL MARKETS	CONSUMERS
JULY 2010	DIRECTIVE CRD3 : NEW RULES ON REMUNERATION, PRUDENTIAL REQUIREMENTS AND GOVERNANCE OF FINANCIAL INSTITUTIONS *		
			REVISION OF THE DIRECTIVE ON DEPOSIT GUARANTEE SCHEMES *
SEPTEMBER 2010	INTRODUCTION OF THE EUROPEAN SYSTEMIC RISK BOARD AND THE EUROPEAN SUPERVISORY AUTHORITIES FOR BANKING, SECURITIES AND MARKETS, AND INSURANCE *		
		REGULATION ON OVER-THE-COUNTER DERIVATIVES *	
OCTOBER 2010		REGULATION ON SHORT SELLING AND CERTAIN ASPECTS OF CREDIT DEFAULT SWAPS (bnc) *	
		REGULATION ON HEDGE FUNDS AND PRIVATE EQUITY *	
DECEMBER 2010	CREDIT RATING AGENCY REFORMS (PART 2) †		SEPA REGULATION (SINGLE EURO PAYMENTS AREA)
MARCH 2011			DIRECTIVE ON MORTGAGE CREDIT
JULY 2011	REVISION OF THE CAPITAL REQUIREMENTS DIRECTIVE FOR BANKS (CRD4) †		RECOMMENDATION ON ACCESS TO A BASIC BANK ACCOUNT
PROPOSALS BEFORE END 2011			
	BANKS AND INSURANCE UNDERTAKINGS	FINANCIAL MARKETS	CONSUMERS
OCTOBER 2011		REVISION OF THE MARKETS IN FINANCIAL INSTRUMENTS (MIFID) AND MARKET ABUSE DIRECTIVES †	
NOVEMBER 2011	REVIEW OF THE ACCOUNTING DIRECTIVES AND THE TRANSPARENCY DIRECTIVE		
	CREDIT RATING AGENCY REFORMS (PART 3) †		
	PROPOSAL FOR A FRAMEWORK FOR CRISIS PREVENTION AND MANAGEMENT FOR BANKS †		
		REFORM OF THE AUDIT SECTOR	
		PROPOSAL FOR A VENTURE CAPITAL REGIME	
		PROPOSAL FOR CENTRAL SECURITIES DEPOSITORIES	
POST JANUARY 2012			
	SOLVENCY II IMPLEMENTING MEASURES	PACKAGED RETAIL INVESTMENT PRODUCTS DIRECTIVE (PRIPs)	
	REVIEW OF THE INSURANCE MEDIATION DIRECTIVE	REVIEW OF THE UCITS DIRECTIVE (Undertakings for Collective Investment in Transferable Securities)	