



**Eurofi 2008 -  
Thursday 11/09/08**

**Session [2] - Plenary: KEY  
ISSUES FOR THE FINANCIAL  
SERVICES INDUSTRY IN  
TODAY'S CONTEXT**

## The Panel

Opening remarks: Didier Cahen; Secretary General, Eurofi

Moderators: **Jacques de Larosière & Daniel Lebègue**; Co-Presidents, Eurofi

Panelists: **Pervenche Bérès**, MEP, Chairwoman, Committee on Economic and Monetary Affairs, European Parliament;

**Meglana Kuneva**, EU Commissioner for Consumer Protection;

**David Vegara**, President of the Financial Services Committee, Spanish Secretary of State for Economic Affairs.

**Karl-Peter Schackman Fallis**, Executive Member of the Board, German Savings Banks Association;

**Georges Pauget**, Chief Executive Officer, Credit Agricole SA;

**Edmond Alphandery**, Chairman of the board of CNP Assurance

## The Debate

**Jacques de Larosière**, co-president of Eurofi, opened its 2008 conference in Nice by observing that since the organisation's previous meeting in December 2007, "we have seen the unfolding of the financial crisis". It was somewhat paradoxical, he said, that a crisis that started in the US sub-prime sector had spread out internationally and particularly in Europe because the financial sector – and banks in particular – were completely intertwined.

Many issues were at stake, he said, including the need to regain confidence and respect for the markets; the need to rethink regulatory and supervisory roles and functions; a rethink of financial business models, "which have slid into a market-trading oriented machine and away from a more classical intermediation role where clients were important and known by financial institutions; the need for further transparency".

The theme of the conference – how further EU financial integration can foster economic growth and increase confidence – could not be more

timely, according to **Pervenche Bérès**, MEP, Chairwoman, Committee on Economic and Monetary Affairs, European Parliament. There was a lot to do in order to bring about this integration "and I am not sure we have been moving ahead as quickly as we should have been". The topic was even more important because financial market integration was not, in fact, fostering growth and jobs. "Too much reliance on the financial markets has had a negative impact on growth," she added.

Ms Bérès quoted ECB president Jean-Claude Trichet, in comments to the European Parliament, as saying "there will be no status quo. We will never go back to the previous situation." As a result, the way we think about market integration might have to move on. There was a need for "three-level thinking – short, medium and long-term". In the short term, discussions were needed on implementing Solvency II, the CRD Directive and initiatives the Commission was considering on credit rating agencies.

In the medium term, there should be a review of the Level 3 Committees. "There is a strong contradiction between the needs of these committees and the willingness of some member states to move on strengthening their status. For example, she said, it made perfect sense for the powers of CESR, the Committee of European Securities Regulators, to be upgraded to allow them oversight of credit rating agencies rather than create a whole new body to deal with them. But because some governments did not want to give CESR any more powers, they were resisting any action to deal with ratings agencies. "This is not reasonable," she said.

In the long term, 2009 – an "in-between year" for both the Parliament and the Commission because of European elections – should be used to reflect on the future shape of financial markets architecture and supervisory structures in the EU. A committee of wise men and women could oversee the process. Without government commitment to change, "we will not restore confidence and the conditions to boost growth and jobs in the EU and worldwide".

**Meglana Kuneva**, EU Commissioner for Consumer Protection, shifted the focus to the consumer, stressing the fact that consumer sentiment was very important. Moving from a consumer protection focus to a market and policy focus was crucial in a time of reduced economic growth, Ms Kuneva said, adding her support to Mr de la Larosière's comments about the importance of regaining respect and confidence in the market.

"Today we have a new currency emerging and that currency is not the euro – it is trust. If people do not trust the market, they will not use the market." For consumers to actively participate in the financial services market, they had to feel as confident and competent in dealing with financial services products as they did in buying other goods and services

Nice, September 2008

THE THINK TANK DEDICATED TO FINANCIAL SERVICES IN EUROPE

11 bis, rue Mansart - 75 009 Paris - FRANCE - Tel.: +33 1 40 82 96 03 - Fax: +33 1 40 82 96 03 - [www.eurofi.net](http://www.eurofi.net)

and they should reap the benefits of the internal market in terms of more choice and lower prices. But consumers were not currently well served by financial services groups because there were big obstacles in obtaining and understanding relevant information from the industry.

“The consumer is already overwhelmed by information, but it rarely informs them. It is complex, incomplete and sometimes misleading,” the Commissioner said. “The key words in my consumer strategy are ‘facts’ and ‘consumer empowerment’.”

A consumer markets initiative launched at the start of 2008 stressed the need for evidence-based policy and the Commission had been collecting evidence about the reality for financial services customers. Commission data showed that up to 40% of consumers found it difficult to compare financial offers on products such as current accounts, mortgages and investment services, with older and less-educated consumers being worst affected. “Incomplete and insufficient information is among the biggest barriers to cross-border shopping for financial services.”

The proportion of customers who dared to find a better deal in another country was very low. “We cannot claim we have one market – we do not have one seamless market where consumers feel welcome and well-cared for,” Ms Kuneva added. “Consumer choice is what drives markets towards delivering the most useful and valued services, which is in business’s interests. We need empowered consumers able to choose using comprehensive and clear information that they understand.”

How do we achieve this empowerment, she asked? By improving financial education and pre-contractual information and by addressing a lack of transparency in the financial services industry to allow informed choices. Consumers’ lack of understanding of financial services would worsen as more people became increasingly reliant on the industry and the Commission had launched three financial education schemes to help tackle the problem. The first was a section on financial services in the European School Diary, which included articles on consumer issues and was distributed in schools. Secondly, it had launched an online education project aimed at adults and finally, it had started a web-based financial literacy programme for primary and secondary school teachers.

When it came to pre-contractual information, people wanted clear and complete information without jargon, and they wanted standardised information sheets to allow ease of comparison. A standardised form would be available once the Consumer Credit Directive was implemented in May 2010. Information on investment products would also be standardised as part of the revision of the UCITS directive.

The Commission needed to better understand consumer choices, Ms Kuneva said. “There are certain circumstances that make consumers deviate from predicted behaviour and these can be costly.” Faced with lots of complex or unappealing information, people take mental short cuts to avoid having to process all the information. “Often they will fixate on just one part of the contract and ignore the rest, or their choice might be determined by inconsequential factors.” As an example, she said that it had been found that including images of a smiling woman in leaflets offering consumer credit boosted take-up of the product by the equivalent of cutting monthly interest rates by half a percentage point.

Information should not be excessively complicated, but “comparing the costs and benefits of bank accounts is like negotiating a multi-dimensional labyrinth. Consumers find it difficult to determine the best offer because there are just too many contingencies and fees.” A UK study had found that 81% of the fees on which the industry relies were largely invisible to the consumer. “When asked how much they were paying in bank charges for having insufficient funds, many consumers did not know even after the charges had been imposed,” she said. “How can we claim we have an effective market with this level of consumer awareness?”

The Commission had looked at bank fees and those involved – experienced professionals – had found it difficult to untangle the information on bank websites, with 69% of websites requiring further clarification from the banks to be understood. “What exactly are we expecting the consumer to do in such a market?” Ms Kuneva asked. “People want an overview of information on costs and conditions on a dedicated website and we will be paying particular attention to this in future.

“We cannot build a pan-European retail financial market when consumers are deterred by a lack of information, a lack of trust and the absence of even a possibility of informed choice,” she continued. “It is my aim to ultimately provide consumers with the tools and environment they need to interact on an equal footing with financial services providers. An integrated retail financial market must happen. If we want it to be competitive, effective and safe, it will have to be a market that ultimately works for consumers.”

Coming up to a decade after the advent of the Financial Services Action Plan, it was clear that the institutional framework for financial services had seen a major overhaul, said **David Vegara**, President of the Financial Services Committee and Spanish Secretary of State for Economic Affairs.

Nonetheless, we were in the midst of dislocation and there were three inter-related priorities.

Nice, September 2008

THE THINK TANK DEDICATED TO FINANCIAL SERVICES IN EUROPE

11 bis, rue Mansart - 75 009 Paris - FRANCE - Tel.: +33 1 40 82 96 03 - Fax: +33 1 40 82 96 03 - [www.eurofi.net](http://www.eurofi.net)

- Restore the normal functioning of the financial system and strengthen the EU legal framework to prevent and manage crises
- Implement reforms that take into account the lessons of the turmoil
- Tackle the remaining barriers to financial integration

In terms of restoring normality, the Ecofin plan of 2007 was still on track but we had to acknowledge that the impairment in the normal functioning of the markets was far from being corrected and it was important to maintain a focus on the four axes of the framework – transparency; valuation; prudential framework and market functioning. “Formal co-operation needs to be complemented with more harmonisation and legal tools.”

Learning the lessons of the turmoil was a more long-term process with a more global dimension that would involve looking at how to reform the system to reduce the extreme cyclical behaviour of liquidity, credit and asset prices and how to incorporate counter-cyclical measures. It was important to reduce or at least neutralise the natural pro-cyclical bias of capital regulations and fair value accounting, Mr Vegara said and there was a need for better policy on hedge funds. “The idea that hedge funds and other non-regulated financial entities can be allowed to operate with no oversight and no information requirements has been refuted by recent events,” he added.

In terms of advancing financial integration, Europe was leading on this agenda, but it was very important that this leadership had results. Understandably, there had been a “slight renationalisation of focus” as a result of the turmoil. “In times of anxiety and turbulence, we tend to care more about our markets, our financial system, our banks. But even if it is natural, we should be cautious about letting this go too far. It would be a mistake.”

European markets had been resilient as a result of financial integration and “perhaps we would have been even more resilient if there had been less fragmentation and more liquid private debt markets”. Projects such as T2S, the code of conduct and SEPA all had a sound economic rationale because of their impact on transaction costs. “Our job as policy makers is to stimulate and facilitate their implementation by recalling the long-term benefits.” Eurofi’s proposals in this area were provocative and worth considering, he added.

On cross-border supervision, it was important to keep solo supervisors as a main part of a reformed group supervision regime. “Home supervisors need a strong role but in many aspects regarding subsidiaries, host supervisors should have a lot to say,” he said. One point that had not been

sufficiently discussed was the need for incentives to monitor and maintain powers at a local level where responsibility would be demanded, including political responsibility. Nonetheless, a review of the Level 3 Committees and their role was needed.

“This is a time for prompt action, lucid leadership by financial authorities and calm confidence,” Mr Vegara concluded. “We need to restore confidence and curb uncertainties.”

There was at least one thing of which everyone at the conference should be very proud, said **Karl-Peter Schackmann-Fallis**, Executive Member of the Board, German Savings Banks Association. The ECB’s ten-year stewardship of the euro had seen a stable currency, contrary to the expectations of some and it had been coupled with a ten-year long success story of financial market integration.

“The euro has been an important driver for the financial markets. The Asian crisis, the September 11th crisis and the current sub-prime crisis have not really been able to affect our currency. And what is the secret of this success? Confidence,” said Mr Schackmann-Fallis. “All market participants trust the ECB and their measures for stability. In the last 14 months in particular the independent ECB has done a good job. Its liquidity policy ensured the functioning of the money markets.”

It might still be too early to draw a detailed picture of all aspects of the sub-prime crisis, but some conclusions were already clear:

- Firstly, what started in one specific sector of finance in the US very quickly spilled over the Atlantic, proving the extent to which the financial systems are interlinked.
- The US sub-prime crisis is a general crisis of confidence among financial market participants. The last 14 months have shown – dramatically – the limited value of ratings, which failed in the sustainable evaluation of structured securities. Consequently, market participants did not trust each other. This crisis of confidence also restricted the distribution of liquidity on the interbank money market.

The main reason for this was the creation of new and complex instruments for the transfer of credit risks, in combination with large banks engaging in an “originate and distribute” business model that amplified the consequences of credit excesses in the US mortgage market. “These new instruments of credit risk transfer distributed fear instead of risks,” he said. And in doing so, they reduced confidence and trust in the system and its participants, making it unsurprising that the turbulence in a specialised segment of the US mortgage market developed into general turmoil on credit markets and a crisis of confidence between the banks.

Nice, September 2008

Secondly, in Europe and in America many banks that had been seen as solid pillars of the financial system got into severe trouble and had to admit a heavy engagement in the problematic market segments: Citigroup, Merrill Lynch, Bear Stearns, UBS, Société Générale, Deutsche Bank, and some of the Landesbanks in Germany as well, just to mention a few.

Thirdly, while innovation on the financial services market was important, the current crisis showed that a rush towards innovation should not lead us to give up traditional, conservative, prudence-oriented banking and commercial behaviour. Europe should try to avoid the mistakes that had been made on the other side of the Atlantic, fostering instruments that have a stabilising effect, such as long-term fixed interest rate products, and a 'conservative' assessment of value.

In the area of International Accounting Standards, "I appreciate the fact that the fundamental principle of the former 'mark-to market' euphoria is under discussion," said Mr Schackmann-Fallis. "There is currently a debate on how to preserve the virtues of the more conservative European evaluation techniques."

Fourthly, the pluralism of banking markets helped to contain the risk of contamination in Europe. "Small and medium sized banks focusing on their local and regional markets were not affected by this turmoil at all," he pointed out. It was important, therefore, not to focus just on consolidating banks into ever-bigger units, all of them governed by the same business model. That would create even bigger systemic risks in years to come.

Last but not least, he said that the European Savings Banks Group had always favoured a supervisory architecture based on the existing framework – but with a significant improvement in co-operation between national supervisors and with more convergence in supervisory practices. "Europe needs a supervisory system that is flexible enough to deal with the concern of supervising the large groups and conglomerates working on a cross-border basis, as well as keeping supervision as close as possible to the relevant national, regional and local markets," he said.

**Georges Pauget**, Chief Executive Officer, Credit Agricole, asked what lessons had been learned so far from the crisis and what were the key concerns?

Current events had gone beyond a normal boom and bust cycle and the financial services industry bore an important part of the responsibility for what happened, as had been recognised in the July report of the Institute of Institutional Finance (IIF) on 'Best Market Practices'. "Market weaknesses must now be addressed and work has already started, both in Europe and the US, on a series of complex issues including: risk management, compensation policies, liquidity risk, conduits and securitisation, valuation,

the rating process, credit underwriting issues, as well as transparency and disclosure," he said.

"While we all agree that increased transparency and disclosure is key to restore financial stability and market confidence, the emphasis should be on relevant disclosure, rather than just more." While new financial complexity coupled with weak market practices certainly bore a big responsibility in the crisis, so did pro-cyclical elements of regulation. "In this context, there are at least two issues that we need to start analysing thoroughly if we are to find any sustainable solution to the current turmoil."

(1) The Basel II prudential framework. The crisis occurred before the new Basel II provisions were fully in place and Basel II will improve incentives for risk management and market disclosure and enhance capital regulation and supervision. However, given that Basel II is partially built on historical data, it may turn out to be too pro-cyclical, meaning that the banking system is not best placed to play the counter-cyclical role it would normally play. The recommendations from the Financial Stability Forum that supervisors assess, in 2009, the degree of cyclicality of the Basel II/CRD framework were welcome because "it is an urgent issue – pro-cyclicality will have a strong effect on the real economy in the forthcoming months."

(2) Fair value accounting has also played an important role in the recent financial turmoil. The very idea that market prices provide the best possible indication of value is partly flawed and needs to be addressed. What should be the approach?

There were two issues: "when" should we apply the fair value measurement and "how" should we apply it when markets are illiquid.

"When?" was the most important issue and related to the scope of fair value accounting for financial instruments. "At Crédit Agricole, we share the view of the International Banking Federation that fair value is not relevant for all types of financial instruments and that a mixed valuation model must continue to apply in order to better reflect the economic reality and diversity of business models." The bank had strong reservations about IASB's plan of fair valuing all financial instruments. For financial instruments not used for trading purposes, such as loans, fair value did not necessarily provide better information and amortised cost was more appropriate. Even for trading instruments, "the current turmoil has pointed out some difficulties and concerns when liquidity dries up".

On how to measure fair value, Mr Pauget said there should be a review of fair value accounting in temporarily illiquid markets. One option was the "mark-to-model" approach, where a mechanism could be established for

Nice, September 2008

THE THINK TANK DEDICATED TO FINANCIAL SERVICES IN EUROPE

11 bis, rue Mansart - 75 009 Paris - FRANCE - Tel.: +33 1 40 82 96 03 - Fax: +33 1 40 82 96 03 - [www.eurofi.net](http://www.eurofi.net)

smoothing market prices over a period of six months to one year to serve as a yardstick for writing down financial assets.

“Whatever the final solution we opt for, it is essential that all these valuation issues be addressed to draw a complete and not misleading picture of the impact of the current market turmoil,” he added, noting that IASB was analysing the issue but also that the industry should have an input on any changes.

The turmoil had also revealed significant weaknesses in the regulatory framework for liquidity management and liquidity risk management, not helped by there being 27 different regulatory systems of liquidity in Europe. “Needless to say, this is very costly, burdensome and far from optimal.”

Large international banks have global approaches to liquidity risk management using elements that are not taken into consideration in national ratios. “It is essential that these models and internal management systems be validated by regulators and harmonised,” Mr Pauget said. Furthermore, large cross-border groups should be able to manage liquidity on a group basis – and according to a principle-based approach rather than in the form of a rulebook. Only a principle-based approach would fully embrace the complexity of liquidity management by banks and be flexible enough to adapt to changing market conditions.

“The current regulatory approach to liquidity issues is ill-adapted to market conditions,” the Credit Agricole chief said. “Illiquidity has been the price to pay for excessive sophistication in financial instruments.” The fact that there were now only a limited number of players on the market, particularly in structured products, combined with a poor degree of substitutability between financial products, limited liquidity. “One reason liquidity dried up so quickly is because market players are predominantly sellers because they are afraid of increasing losses. This is related to the accounting method used. To avoid such panic behaviour, players should have at their disposals different solutions according to their own investment reasons.”

Mr Pauget suggested one such option – the creation of a new class of assets, designed for a long-term holding period. This would allow banks to transfer loans from their trading book to a special class on their banking book. “This option would limit the need for capital and reduce the withdrawal of liquidity,” he said.

Recent events had revealed the limitations of today’s supervisory system in Europe, in particular for large cross-border active groups, he continued. “Based mainly on national processes, the current system is neither efficient nor sustainable. As banking consolidation continues in Europe, these limitations will become increasingly more apparent. We need to

review the current structure of supervision in Europe and move from a national to a European approach.”

This meant that the Level 3 Committees needed to be reinforced, with the introduction of the “lead” or “group” supervisor model. Looking at central bank policy on crisis management was also important.

In the current crisis, it was also vital for the industry and authorities to maintain the focus on consumers and savers. “As banks, we cannot hope to remain sustainable in the long-term if consumers have no confidence in our products and in the structures of our markets.” The turmoil had shown the need to revisit the issue of deposit guaranty schemes in the European Union.

The financial crisis had already cost €250bn (a sum that would very rapidly come to seem relatively minor), said **Edmond Alphandery**, Chairman of the board of CNP Assurance. There were also huge political costs, which would be borne by member states and European institutions, if they were not prepared to address future pan-European crises. “The fact that EU banking integration has gathered speed is good news, but there is a drawback – the steady growth of cross-border activity has led to increased risk of contagion outside national borders.”

But despite this risk of cross-border contagion, the supervisory system remained very fragmented, with credit risk being managed by central banks and the solvency crisis managed by financial ministers. Furthermore, the principle of subsidiarity meant that only policies that had a clear common interest across member states should be implemented at EU level. As a result, any rescue of institutions with cross-border activities involved a number of different central banks and finance ministries in home and host countries, all of which had different rules and techniques. “Maintaining financial stability in these circumstances is a real challenge,” Mr Alphandery said. “How do you allocate tasks, how do you avoid panic across the EU and who is meant to pick up the bill when a bail-out becomes unavoidable?”

So far, four banks had needed help, none of them with significant activities outside their home countries, but there was a lack of co-ordination among national authorities, especially in the case of Northern Rock, which pushed out the cost to the public sector to €70bn. The problems would be much worse in the case of a cross-border institution and the risk of systemic crisis spreading across member states was increased.

While there had been progress on the convergence of supervisory roles, “as long as national authorities alone have responsibility for rescue, how can we blame them for focusing on their own national interests and those

Nice, September 2008

THE THINK TANK DEDICATED TO FINANCIAL SERVICES IN EUROPE

11 bis, rue Mansart - 75 009 Paris - FRANCE - Tel.: +33 1 40 82 96 03 - Fax: +33 1 40 82 96 03 - [www.eurofi.net](http://www.eurofi.net)

of their taxpayers?" he asked, presciently. "It is high time to enhance pan-European supervision and the best starting point is where the main risks lie – ie cross-border financial institutions. Because this touches upon national sovereignty, this is a sensitive issue, but when there are cross-border risks, we should take for granted that financial stability is in the interests of all member states."

While subsidiarity in favour of member states should apply when problems did not spill over national borders, when the crisis expanded abroad, "would it not be a logical application of subsidiarity principles to allow EU institutions to take charge," Mr Alphandery asked?

The Commission had put out two important texts for examination during the French presidency, which were good first steps to improve supervision of cross-border financial groups. However, Eurofi had pointed out the insufficiencies and lack of ambition in the texts and made some interesting proposals on the subject. "We need political impetus at EU level to overcome fears of distortion of competition and enhance a common vision for supervision of cross-border groups," he said.

There were three risks from a crisis involving a cross-border institution.

- Insufficient cohesion in the management of the crisis between finance ministries, supervisors and central banks in home and host countries
- A lack of burden-sharing schemes in cases where a bail-out using public funds is required
- Lack of a European system of deposit guarantee schemes that could have the capacity to prevent panic spreading across Europe

To avoid the spread of systemic risk, three conditions were necessary, Mr Alphandery added. In the euro area, there should be an enhanced role for the ECB and the euro system in macro-prudential oversight in times of crisis; there should be a task force chaired by the head of the ECB if losses have been incurred and there should be burden-sharing schemes to ensure national authorities have the right incentives; and there should be mechanisms to ensure the interoperability of national deposit guarantee schemes.

Nice, September 2008

**THE THINK TANK DEDICATED TO FINANCIAL SERVICES IN EUROPE**

11 bis, rue Mansart - 75 009 Paris - FRANCE - Tel.: +33 1 40 82 96 03 - Fax: +33 1 40 82 96 03 - [www.eurofi.net](http://www.eurofi.net)