DEFINING PRIORITIES TO REFORM THE FINANCIAL REGULATORY AND SUPERVISORY FRAMEWORK

SUMMARY OF DISCUSSIONS

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The Eurofi high level seminar 2010 organized by Eurofi and the Spanish EU Presidency was dedicated to discussing the priorities for reforming the financial regulatory and supervisory framework.

More than 60 leaders from the financial industry and the EU and domestic public authorities, including Finance Ministers, Central Banks, regulators, supervisors, along with several international regulators took part in the interactive and informal debates of this seminar, which saw open and fruitful discussions.

The representatives of the public authorities pointed out the importance of doing all we can to avoid new excesses and considered that a systematic review of prudential measures was essential. However, a balance must be struck between ensuring the financial stability of the system and not stifling economic growth:

1 They highlighted the importance of the orientations given by the G20 and the on-going negotiations conducted by the competent international authorities such as the Basel Committee and the FSB.

2 They also stressed the importance of implementing a common regulatory level playing field at the international level to avoid regulatory arbitrage, which was one of the factors at the origin of the crisis.

3 They insisted that new reforms should be guided by simplicity and pragmatism

4 They highlighted the fact that it is impossible to eliminate failures entirely so measures are also needed to reduce the impact of any future failures that occur.

5 Finally, they are conscious that the multiplication of regulatory measures inevitably has consequences on the financing capacity of financial institutions and that caution is required in the present phase where economic recovery is not assured. Capital requirements are not the only remedy, they stressed, and the quality of capital is as important as the amount required.

On the industry side the main messages put forward were the following:

1 All the industry players present in the seminar recognized the need to reinforce the supervisory system in order to avoid the repetition of a crisis as bad as the one that we are experiencing.

2 They recognized in particular the importance of better ensuring the liquidity of financial institutions. Current regulatory proposals on liquidity are considered to be restrictive. Without going into technical details, one can say that assets and liabilities management methods are a central element of the objective to reinforce liquidity. The private sector is quite disposed to work with the supervisors to solve these questions in an efficient and reasonable manner. The use of well understood and monitored stress tests is an important part of this approach. However, oversight of these areas should not be according to mechanistic formulae.

3 Many industry players insisted that an accumulation of specific measures meant to reinforce the own funds of financial institutions would be an issue, particularly in Europe where financial intermediation represents 80% of the financing of the economy. Initial evaluations show that the total impact of regulatory measures currently envisaged could not be “absorbed” by the market. These representatives pointed out the risk of creating a credit crunch (leading to less credit at a higher cost and the potential for equities market dislocation) in a European economy already penalized by limited growth prospects following the crisis. Such a “regulatory overload” could have very damaging consequences for the economic agents according to them. That is why the assessment of the cumulative impact of new measures is absolutely essential.

4 A number of participants pointed out in addition that a “level playing field” should not only be sought after in regulation but also in supervision. They explained that great differences can be found among the different methods and approaches to supervision. In some countries supervision is mostly “on the ground” and quite intrusive with, for example, a significant number of supervisory staff operating on the premises of the financial institution; in other countries, supervision is much more hands-off. This issue needs to be addressed

since it leads to different behaviours in terms of risk taking in addition to the competitive differences created. It was noted that those countries that came through the crisis best were those with the more intrusive supervisory systems.

5 There was a consensus that size was not the main criterion in establishing systemic risk. The overarching principle should be to link capital requirements to the riskiness of activities and not to the size of the activities or of the financial groups.

6 Some players did not understand why financial institutions which had weathered the crisis with no particular problems, for example companies operating traditional business models focused on transformation of short term deposits into medium / long term lending or financial groups with sufficiently well diversified activities, should be submitted to the same rules (eg "too big to fail" rules, rules for systemically important institutions , or leverage ratios…) as companies with business models which had shown poor resilience during the crisis. This "one size fits all" approach would reduce in an unnecessary way the capacity of the former institutions to lend.

7 Another aspect of this "one size fits all" approach came under particular attack from the insurance industry, which feels that it is being penalised for being a long term investor by the new regulatory frameworks that are being proposed. This is potentially detrimental to stability since long-term investment is a factor in reducing volatility of markets. What might be suitable and appropriate for the banking sector is not right for the insurance sector and other long-term investors.

8 There was less consensus on a European resolution system. While it was agreed that such a system, involving measures such as living wills, would be welcome, it was thought to be very difficult to implement without comprehensive reforms to measures such as insolvency laws.

Main conclusions drawn by Eurofi from the seminar:

1 We think that a streamlined common regulatory and supervisory basis could be defined for achieving an adequate balance between financial stability and economic growth objectives. This requires looking to optimize the effects of the different tools available (eg defining priorities, avoiding overlaps, etc…) rather than just putting them side by side. Communicating on this common basis once it has been defined would help in the short term to stabilize financial markets, reinforce confidence and reduce uncertainty even if all the possible tools envisaged at present are not part of it in a first stage. This common basis could be revisited, if necessary, after a few years.

3 Reinforcing supervision is one of the tools that should particularly be considered in this common basis. Supervision can indeed be a more efficient prevention tool than the multiplication of regulations or rules which often turn out to be imperfect since they can be circumvented and need to be constantly reviewed to follow evolutions and innovations in the market. To be effective supervision should rely on common principles but it should be sufficiently flexible to allow supervisors to exercise their judgement.

4 It is impossible to regulate everything in minute detail and it will lead to moves to circumvent the rules. However, it is important to apply the existing rules properly before building new rules. The events that triggered the crisis were largely the responsibility of institutions that did not apply the existing rules and where supervision was lacking. We will exit the crisis under the existing rules.

5 Those who formulate new rules should always bear in mind the possible unintended consequences of those rules and attempt to deal in advance with any systemic risks.

6 Supervision must take a holistic view of the financial system and must be arranged on a consolidated basis, taking into account all activities performed by each institution.

7 After the publication of the impact assessments by the Basel Committee, Eurofi is committed to foster further dialogue between the industry and the public authorities to achieve efficient and feasible solutions. This dialogue should be initiated at a sufficiently early stage (in any case before the summer).

8 As for the organization of the supervisory system in Europe, we consider that the recommendations contained in the report published in February 2009 should be implemented to establish in the EU a sufficiently consistent and efficient system. The authorities should in particular be provided with binding decision-making powers for mediation in case of divergence of views between supervisors as well as for setting technical standards. If this is not done the report will lose most of its significance.