The Eurofi Financial Forum 2010

An event organized by Eurofi in association with the Belgian Presidency of the EU

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Summary of discussions (drafted by Eurofi)

The Eurofi Financial Forum 2010 was dedicated to discussing the improvements required in regulation and supervision in the global context in the light of the upcoming G20 meeting and the European Commission's on-going regulatory reforms.

More than 220 leaders from the financial industry and from EU and national public authorities[1], as well as several international regulators (from global organizations such as the Basel Committee, the IMF, IOSCO… and from the US and Brazil) took part in the interactive and informal debates of this Forum, that were attended by 800 participants.

Three main topics were covered that are relevant to the on-going reforms of financial regulation and supervision at EU and global level:

- The reform of prudential requirements following the recent Basel agreement and how they will be implemented
- The improvements that can be expected from the creation of the new EU regulatory and supervisory authorities and the conditions necessary for their success
- The importance for financial stability and growth of removing the disincentives to long term investment

1. The reform of prudential requirements following the Basel agreement and how they will be implemented

The public authority representatives explained the decisions that were made in Basel:

- There was a need to strongly increase prudential requirements to prevent a repeat of the excesses that led to the financial crisis
- They considered that by proposing a long phase-in period, which would enable banks to finance the increase required in capital mostly by retained earnings and cost reductions they had worked hard to take into account the possible macro and micro-economic impacts of the higher capital charges.
- They also stressed the importance of implementing a common regulatory level playing field at the global level to avoid regulatory arbitrage and the possible shift of

[1] EU Commission, EU Parliament, European Central Bank, Belgian Presidency of the EU, EU Council, Level 3 committees, National central banks, regulators and supervisors, finance ministries…

regulated activities towards non-regulated areas, which was one of the factors at the heart of the crisis.

- The need to define specific requirements for banks labeled as 'SIFIs' (Systemically Important Financial Institutions) was also discussed because of the potential moral hazard they represent in relation to the belief that they are 'too big to fail', which the crisis demonstrated.

- They highlighted the potential benefit in helping to assess and reduce counterparty risk and possible contagion effects due to defaults that central clearing of eligible OTC derivative contracts and trade repositories could bring.

The industry representatives welcomed the extended implementation period for the Basel requirements while pointing out their potential negative effects:

- The industry players taking part in the Eurofi debate were all concerned by the very significant tightening of the prudential requirements for banks the Basel recommendations would lead to. Combining the increase of Core Tier 1 from 2 to 7% with the restrictions imposed on the definition of Tier 1 equates to multiplying by 5 former capital requirements and by 15 requirements for trading activities, to which must be added extra requirements in terms of liquid assets held by banks.

- The industry welcomed the staggering of the new requirements over a number of years in terms of reducing short-term macroeconomic impacts. However, most banks considered that this phased approach will not sufficiently reduce impacts on financing capabilities:

    - Although most banks can probably reach the level of capital defined by Basel by the end of the timetable, by combining increases in retained earnings and productivity gains, the amount of capital to be raised will inevitably have economic impacts. Indeed, some observers consider that each additional point in the core tier one ratio could lead to an increase in the global industry's capital of 500 billion euros. Banks may not be able to increase their productivity sufficiently to absorb the required increases in capital charges, which would lead them to raise prices or reduce lending as a consequence.

    - The increase in prudential requirements will probably trigger changes in banks' activities, in business models and in the amount of focus on different types of customer segments that are difficult to anticipate at present but that will have an impact on the volume and cost of credit. Some consider that this could lead banks to focus on the most profitable customer segments, which would penalize small and medium-sized businesses and less wealthy retail customers.

    - Because banks finance 80% of Europe's economy, the reforms are expected to have a higher impact in Europe than in the US. Moreover, European banks store the credits in their balance sheets as they lack the substantial support of Government Sponsored Entities (GSEs: Fannie Mae and Freddie Mac). Large European banks also have an essential role in the financing of SMEs, while US banks do not.

- The notion that large banks should require more capital because they represent an additional threat to the financial system is highly questioned. Large banks are not dangerous per se – it all depends on their business model. For example, large banks that have well diversified activities and whose funding is largely deposit-based are probably less risky than smaller investment banks which have portfolios of risky investments and positions and rely on wholesale markets for their funding. A selective approach by national supervisors is of the essence.

- A strong case was also made by some players to reflect the fact that many large institutions had a diversified exposure through their geographic presence and product lines, and so were resilient in the face of the crisis. The effectiveness of Pillar 2 in recognizing individual firm risk was also put forward.

- In the same way the concept of a non-risk weighted leverage ratio was rejected by some players on the grounds that the portfolio of activities and the business model should be taken into account when defining such ratios.

- In addition some insurance industry figures pointed out that the crisis did not affect all sectors in the same way and suggested that prudential measures should be adapted to each financial sector. The calibration of Solvency II should take into account that there is no need for a general increase of solvency requirements for all types of insurance activities, even if lessons from the crisis should be fully drawn (in particular regarding market risk calibration).

- The importance of strengthening supervision in parallel to prudential changes was also pointed out.

    - Prudential requirements on their own do not guarantee a genuinely sound system, pointed out the industry representatives present in the debate. The quantitative measures must go hand in hand with risk management and transparency requirements, as well as improved supervision, so that new risks resulting from financial innovation or the possible transformation of each financial institution's business portfolios, for example, can be identified as early as possible. Micro-prudential supervision also makes it possible to better adjust prudential requirements to the actual risk profile of large financial institutions in particular, which would reduce the possibility of a credit crunch as well as pro-cyclical consequences.

    - Supervision can more efficiently detect systemic weaknesses in financial institutions than the multiplicity 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.

Main proposals discussed during the Forum and main conclusions drawn by Eurofi:

- This debate showed a strong commitment both from the public authorities and the industry side to find ways to make the financial system more resilient while minimizing the impacts for customers and the economy.

- Since the effects of the measures decided in Basel on the financing capacities of financial institutions and on the structure of the industry are difficult to evaluate at this stage and given the timeframe decided for their implementation, it is important to set up global and regional observatories in order to ensure appropriate monitoring of these reforms. These observatories could measure the consequences of the prudential reforms on the activities and business models of banks, analyze the positive and negative impacts of the reform and propose possible adjustments over time in the calibration and architecture of Basel 3, based on their observations.

- Stronger supervision should play a larger part in the G20 agenda. To be effective supervision should rely on common principles and be hands-on and operational. This requires appropriate resources, skilled staff, authority, organization and processes. In addition supervisors should have a clear and unambiguous mandate, operational independence coupled with accountability and a relationship with industry that avoids "regulatory capture".

- The transposition of Basel 3 must be synchronised in the various regions around the world and factor in the impacts on lending highlighted by the observatories presented above.

- Given that the insurance industry weathered the crisis, capital requirements for the insurance industry currently proposed in the QIS 5 should be reviewed so as to let the insurance sector play its traditional role in stabilizing financial markets and acting as a long-term investor.

- Lastly, a review could be carried out to facilitate the development of securitisation and alternative financing mechanisms in Europe, to help the most vulnerable customers by facilitating access to the capital markets for European SMEs, by deploying guarantee and deposit mechanisms, etc..

2. The improvements that can be expected from the creation of the new EU regulatory and supervisory authorities and the conditions necessary for their success

The decision to set up the new EU supervisory authorities is the starting point for a fundamental change in European financial regulation and supervision towards more harmonization.

The new authorities will contribute to further convergence of regulation between Member States by developing common technical standards which are essential to bring about more integrated financial markets. They will also monitor how rules are being enforced by national supervisory authorities and be able to address breaches of Community law, which should lead to reinforced co-operation between EU supervisors.

Attention should be paid to the different factors that will guarantee the success of these authorities:

- The authorities need strong leadership and appropriately skilled staff. They must be ready to use their new powers when required. In this respect the selection of the chairpersons in the coming months will be of the utmost importance.

- There must be an efficient dialogue to ensure a sharing of information not just between supervisors but also between the Authorities, the Member States, the ECB, the ESRB and the Commission.

3. The importance for financial stability and growth of removing the disincentives to long term investment

In the context of efforts to reduce public debt, private investments are increasingly required to finance long-term projects (e.g. infrastructures, new technologies, the needs of ageing populations…). The investments that can offer high long-term risk-adjusted rates of return should be stable but should also be sufficiently attractive to institutional and retail investors. In addition appropriate investment vehicles must be available.

At present, many investors are encouraged by the fiscal, regulatory and accounting frameworks (ie the emphasis on quarterly reporting, fair-value accounting, rules for capital and liquidity…) to adopt a short-term focus which is detrimental to long-term projects and to financial stability due to its pro-cyclical aspects.

For example representatives of the pension funds industry explained that prudential rules could in some cases lead them to reduce investments in equities, which would increase investments in bonds and short-term instruments providing less yield and which would provide lower returns to savers in the long term and lower pensions in the future.

Speakers on the panel proposed a range of options to reduce these disincentives to long-term investment:

- Similar tax treatment for debt and equity financing
- An optional prudential and accounting framework for financial institutions that has specific valuation, prudential and reporting rules for long-term commitments
- An EU framework for financing PPPs (Public Private Partnerships)
- An EU framework for a long-term investment vehicle for households with specific redemption rules and appropriate investor protection for retail clients.
- Rules to enable issuers to appropriately reward stable investors.

The development of these options requires political momentum. In order to prepare the basis for this, many speakers supported Eurofi's idea for a European plan to encourage long-term investment. Such a plan would comprise academic and economic evidence on the role played by long-term investment, identify and prioritise the present impediments to long-term investment, analyze best practices existing in Europe and around the world and make the appropriate recommendations.