

### A stock-take of current financial reform proposals

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### Aug 2009

#### Introduction

The ongoing crisis has highlighted several key deficiencies in the current financial system which would need to be addressed if we are to have a financial system which is sustainable and supports prosperity and provides support to the real economy. Some of these are

- There was an excessive focus on the stability of individual institutions and too little focus on the stability
  of the system as a whole.
  - The issue of systemic stability needs to be at the heart of the regulatory agenda.
- The scope of regulation was too narrow with several institutions such as hedge funds, private equity firms and special investment vehicles falling outside the scope of most bank regulation even as they performed bank like functions. Others such as investment banks and money market funds were too lightly regulated. Markets such as those in derivatives and securitized bonds were also left largely unregulated. In a number of jurisdictions, especially tax havens, the overall regulatory regime ranged from non-existent to unsatisfactory.
  - The scope of regulation needs to be comprehensive and it should extend to all jurisdictions, all institutions, all markets and all instruments.
- The regulatory regime was too procyclical with capital adequacy, loan loss reserve rules, credit ratings, marked to market accounting rules all adding to the already inherently procyclical nature of financial markets and thus amplifying business cycles.
  - The new regulatory regime needs to be explicitly counter cyclical.
- Many financial institutions were allowed to become too big, too complex or too interconnected to fail
  where their failure would have had catastrophic consequences on financial markets as was highlighted
  after the collapse of Lehman Brothers. Far from such institutions having to have an extra safety margin of
  capital and liquidity protections as would have made sense, many had less than for comparable smaller,
  simpler and less connected institutions partly as a result of arbitrage opportunities and the flexibility
  provided to them under the Basel II capital accord.

- The moral hazard problem where these institutions enjoy an implicit subsidy from the possibility of public rescue made matters worse. That is why the new regulatory regime has to find a satisfactory way to deal with such systemically significant institutions either by downsizing them or by introducing extra safety margins which makes them internalize the systemic risks they pose.
- The long bull market and low interest environment led to regulatory complacence where the availability
  of liquidity across several markets was taken as a given and the 'just in time' liquidity regime where short
  term borrowing was used increasingly to fund longer term assets contributed in a large way to the
  vulnerability of the financial system.
  - The new regulatory regime must put the need to maintain adequate and robust liquidity, which has been long ignored in regulation, at the heart of regulation this point forward.
- The fact that there did not exist proper and sufficient legal and financial mechanisms to allow an orderly
  winding down of financial institutions added significantly to the uncertainty that surrounded the viability
  of financial institutions. While mechanisms were designed on the go in most major OECD economies,
  these were ad hoc and inefficient from the perspective of both the tax payer and market confidence.
  - That is why one of the priorities for the new regulatory regime needs to be to formulate a legal and fiscal regime that allows the orderly, flexible and quick winding down or takeover of large, complex and interconnected financial institutions both at a national as well as an international level.
- The lack of proper international supervisory and regulatory oversight stood out in the crisis where regulatory and oversight gaps in the supervision of internationally active financial institutions helped cause the crisis and the lack of proper co-ordination or supranational authority helped prolong it.
  - One of the key requirements for regulatory and supervisory reforms is to introduce mechanisms and institutions that facilitate an effective international supervision program, help co-ordinate regulatory regimes and enable internationally co-ordinated crisis management.
- The pre crisis financial system was characterized by 1) too little capital 2) of insufficient quality and 3) excessive borrowing and embedded leverage. This low quantity and quality of capital eroded the shock absorption capacity of the system and the leverage helped amplify losses and contagion.
  - The new financial regulatory regime needs to have much stricter provisions for the quality and quantity of capital as well as limit total leverage in the system.
- The financial system is rife with mis-aligned incentives and conflicts of interest in the compensation of
  financial market participants which encourage short termism, excessive risk taking and allow them to
  ignore due diligence all of which compromise systemic stability and market integrity. This was particularly
  evident in the case of the origination of securitization, trading by investment banks and the issue of credit
  ratings.
  - A proper alignment of incentives needs to be at the heart of the new financial regulatory system.
     At a minimum, the lack of due diligence in the origination and issue of securitized bonds, the

conflicts of interests that prevail in credit rating agencies and the risk enhancing bonus schemes that are widespread in the financial sector all need to be addressed urgently.

- The crisis also highlighted the inadequacies of consumer and investor protection in current regulations which were highlighted by the Madoff scandal, the lack of transparency of financial institution exposures and losses and the sale of complex ill suited securities such as certificates to retail customers.
  - The ongoing regulatory reform needs to increase transparency in the system, improve investor protection and institute enhanced consumer safeguards.

# What has been proposed thus far

### 1. Supervisory Structure and Agency Reform

#### US

The main proposed changes to the current institutional structure for supervision in the US are 1) the creation of a new Consumer Financial Protection Agency 2) the creation of a new National Bank Supervisor as an agency in the Treasury and 3) the setting up of an office of National Insurance within the Treasury. Under current proposals, the Federal Reserve and Federal Deposit Insurance Company (FDIC) will retain their current roles in the regulation and supervision of state chartered banks. The Security and Exchange Commission (SEC) and the Commodity and Futures Trading Commission (CFTC) would also maintain their current authority as market regulators though the regulatory frameworks for futures and securities will be harmonized.

The US aims to eliminate the Thrift charter and with that the Office of Thrift Supervision (OTS) and have all federally charted deposit institutions and branches of foreign banks supervised by the new banking supervisor. It further aims to close loopholes in the Bank Holding Company act which have allowed non bank financial companies to perform bank like function with inadequate supervision. Furthermore the administration has indicated that it will introduce further restrictions on the commercial activities of firms that own insured depository institution. It has also indicated that it will end the SEC's supervision of Investment Banks which will instead be supervised by the Federal Reserve.

The US has set in motion a process to identify what changes in the structure and governance of the US Fed would be needed so these are more consistent with its expanded authority and responsibilities. The Fed, in consultation with external experts and the Treasury is expected to report on this by the end of October 2009.

There will also be a report drafted jointly by the treasury and supervisory agencies with inputs from outside experts on a fundamental reassessment of bank supervision which will be presented on the  $1^{st}$  of October 2009.

#### EU

The Commission and Council have agreed in principle to create three new pan European Supervisory agencies collectively known as the European System of Financial Supervisors (ESFS) to address current deficiencies such as insufficient co-operation and information exchange on cross border issues and institutions, the difficulty of joint action across borders and different interpretation and application of rules. These are intended as an upgrade to and replacement for the three existing financial services committees, also known as the "Lamfalussy level 3 Committees". The Commission is expected to introduce the relevant legislation in the autumn of 2009.

The plan is not to replace the national supervisors but for the ESFS to become an operational European network with shared and mutually reinforcing responsibilities. The three new agencies will be 1) the European Banking Authority 2) European Insurance and Occupational Pensions Authority and the 3) European Securities Authority.

The idea is for the agencies to take on all the functions of the current committees of supervisors but have increased responsibilities, defined legal powers and greater authority. Chief amongst their functions would be to 1) develop a single set of harmonized rules 2) improve the supervision of cross border institutions 3) help settle disputes between national supervisors 4) have full supervisory power over certain entities such as credit rating agencies and pan European clearing systems 5) collect relevant micro prudential information from national authorities and 6) improve co-ordination in a crisis

Each of the agencies is expected to have a board of supervisors comprised of the highest level representatives of the relevant national authorities and chaired by the chair of the respective European supervisory agency. In addition a representative from the commission, from the ESRC and supervisors from EFTA-EEA countries are expected to be observers. There will also be a steering committee overseeing the whole of the ESFS comprising of the heads of the three agencies and a representative from the commission.

Under the Capital Requirement Directive that has been recently agreed, the EU has to put in place relevant colleges of supervisors for all large cross border financial institutions operating in Europe.

### UK

The UK has decided not to introduce any major changes to its supervisory structure at this time and the FSA is to remain the consolidated supervisor. However, the UK plans to increase the authority of the FSA by 1) giving it an explicit mandate for financial stability 2) enhanced supervisory powers 3) increased information gathering power 4) stronger tools for taking action against mis-conduct and the 5) stand alone power to impose restrictions on short selling. The UK is also considering making the FSA accountable to the national audit office.

### **Commentary and Critique**

Neither the US nor the EU proposals go far enough. The US has chosen to hold retain its fragmented (across functions and between the federal and state level) supervisory regime more or less intact primarily to minimise the risk of turf warfare breaking out between the various agencies and the relevant congressional committees that oversee them (because it brings influence and campaign dollars). Despite this, the very modest proposal to abolish the thrift charter and combine the work of the OCC and the OTS under a new national bank supervisor has already come under severe attack from the OCC as well as the OTS and their relevant constituencies. On many of the derivative markets the SEC and the CFTC will continue to hold joint responsibility which led to several problems in the past.

The EU, despite paying lip service to the increased need for financial integration and the principles of a single market has put forward relatively unambitious proposals where the national supervisors retain most of their functions and power. Also while it is not clear that the separation of supervisors along functional lines is the best model, the EU has kept that model without a proper debate. As a result the EU supervisory landscape, like the US one, remains fragmented across member states and the EU as well as across functions. But unlike the US there are fewer functional overlaps at the EU level so a reduced possibility of arbitrage and conflict.

While in line with the original proposal the ESFS agencies retain the power to impose binding agreements in the event of disputes between national agencies, this does not apply to any dispute that might have fiscal consequences. This watering down is the result of UK opposition and severely impacts the crisis resolution and

co-ordination powers of these institutions given how big a problem cross-border burden sharing proved to be in the ongoing crisis in the EU.

#### 2. Systemic Risk Regulator and Co-ordination Body Creation

#### **United States**

The United States has proposed the creation of a Financial Services Oversight Council to 1) facilitate information sharing and co-ordination 2) indentifying emerging risks 3) help identify firms with a systemic relevance 4) help resolve jurisdictional disputes between regulators 5) provide a forum for discussion of critical matters

This council is to be comprised of 1) The Secretary of the Treasury who will also serve as Chairman 2) Chairman of the Board of Governors of the US Federal Reserve System 3) the Director of the soon to be formed National Bank Supervisor 4) the Director of the soon to be constituted Consumer Financial Protection Agency 5) Chairman of the SEC 6) Chairman of the CFTC 7) Chairman of the FDIC 8) Director of the FHFA (Federal Housing Finance Agency). The plan is for the council to be supported by a dedicated secretariat located at the Treasury.

It is proposed that the Council will have power to gather information from any financial firm on financial stability and will work through referring emerging risks to relevant regulators which have the authority to respond. The council is also to advice the Fed Reserve which has been designated to be the regulatory authority for systemically significant firms on the identification of systemically significant institutions based on (size, leverage and interconnectedness) as well as of critical systemically important infrastructure such as payment, clearing and settlement systems.

### EU

The EC had proposed a creation of a European Systemic Risk Council (ESRC) the principle of which the European Council has agreed to though the name of the body has been changed to European Systemic Risk Board (ESRB). This will have a mandate to 1) monitor and 2) assess and 3) issue warnings and 4) recommendations about potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole in the EU. It is also meant to 5) monitor the follow up to its warnings and 6) liaise with the IMF, FSB and third country counterparties

It is proposed that the Council will be comprised of 1) President of the ECB 2) A Chairperson who will be elected by the ECB council 3) A Vice Chairperson to be elected by the ESRC members 4) Governors of the 27 member state central banks 5) Vice President of the ECB 6) Chairpersons of the three new proposed pan European Supervisory Agencies 7) a Member of the European Commission.

Given the large membership size, it has been proposed that the ESRC will have a smaller steering committee comprising 1) the Chair 2) the Vice Chair 3) 5 Central Bank presidents 4) the Chairs of the three proposed Supervisory Agencies and 5) the EC member.

It has been proposed that the ESRC will be set up as a body without legal personality under article 95 of the EC treaty and it will have a mandate to cover the whole financial sector without exception. While the ESRC will not have any legally binding powers, it is expected to exert influence through the quality of its analysis and by the virtue of its high powered membership. The council will be accountable to the European Parliament and the European Council.

### **United Kingdom**

The UK proposes to create a Council for Financial Stability (CFS) for the purpose of 1) increasing the coordination between all financial authorities 2) formally evaluating risks identified by the Bank of England in its Financial Stability Report and an 3) assessment of the necessary actions that need to be taken to counter the risks.

It has been suggested that the membership of the council shall consist of 1) the Treasury 2) the FSA 3) The Bank of England with the Chancellor of the Exchequer as the Chair.

The council will have published terms of reference, will meet regularly and have a high degree of public transparency and accountability with quarterly published minutes. It will have regular standing meetings to discuss the authorities' assessment of systemic risk. It will also meet as and when required when particular risks to financial stability arise and actions to resolve these risks need to be considered. While the regulatory bodies will retain all of their existing responsibility, the CFS is to serve more as a means of co-ordinating action both nationally as well as internationally.

# **Commentary and Critique**

It is encouraging that all three of the jurisdictions have agreed to set up independent bodies to identify systemic risk as well as increase co-ordination across supervisors including central banks. The size of the bodies varies hugely between the EU on the one hand (more than 30 thought there is a smaller 'steering committee') and the UK (just 3). Both are risky where too many members can lead to total indecision and too many perspectives on the one hand and too few members bring too little diversity of opinion and are susceptible to not being able to look beyond the blinkers. On this aspect the US model seems best.

In all three cases the systemic risk bodies don't have executive powers (the US body can seek information pertaining to systemic risk) but can only urge the regulators with the executive powers to act. While it is helpful that all the major regulators are members but it is possible that problems might arise say when a majority of the non central bank members identify a risk, the central bank disagrees but is asked by the systemic risk body to take corrective action. It might have been better to give these bodies more teeth to act. The weakest of the three is the EU body which primarily has central bank members and no representation of any fiscal authority which is a serious drawback especially as a fiscal authority (ministry of finance) is more likely to be react to the likelihood of systemic risk build up since it will have to foot the rescue bill. The US body seems to be the strongest and is also likely to play a significant co-ordination role in the fragmented regulatory landscape that prevails there.

### 3. Regulating Systemically Important Institutions

#### US

The administration has proposed that any systemically significant financial firm would be subject to consolidated supervision and regulation irrespective of its legal form. The US Federal Reserve Board is to identify these firms and will be accountable for their consolidated supervision and regulation as 'Tier 1 Financial Holding Companies (FHC). The Financial services oversight council is expected to help identify these firms on the basis of the 1) potential impact of their failure 2) their size, leverage, interconnectedness and funding mismatch and 3) their importance as a source of credit and liquidity to the economy.

Importantly, the proposal for consolidated supervision covers the parent and all its subsidiaries whether regulated or not, whether US or foreign.

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The Fed has been given the authority to collect information (pertaining to their systemic significance) from Bank Holding Companies above a certain size no matter who their primary regulator is which will require a repeal of the Gramm-Leach-Biley Act that restricts the Fed's authority.

The administration plans to help internalize some the systemic risk that these firms pose to the financial system by applying stricter and more conservative prudential standards – on liquidity, capital and risk management to the Tier 1 FHCs. Moreover these firms will also be subject to higher disclosure standards.

However the administration plans to continue to allow financial holding companies to engage in the whole range of financial activities permitted under the GLB act which means that it has rejected a separation of investment and commercial banking.

#### EU

There is as yet no new proposal for the identification and supervision of systemically important institutions at the pan European level. The likely scenario is that the 40 or so financial groups which have a significant cross border presence in the EU (and hold 70% of bank deposits in the EU) will be treated as the de facto systemically significant institutions.

All of these will have colleges of supervisors overseeing them though their supervision remains primarily a national responsibility. The colleges of supervisors are expected to help co-ordinate supervision for these entities. The three proposed pan European supervisors are also meant to help ensure better co-ordination across borders and are likely to become increasingly important in the supervision of systemically important pan European institutions though the discussion remains very sketchy. They are likely to play a particular role with regards to resolution of disputes between national supervisors where there decisions will be binding unless there is fiscal dimension involved.

It is likely that following international discussions at the FSB and the G-20 that larger EU institutions would be held to tougher prudential standards.

#### UK

The UK government has explicitly rejected mandating restrictions, such as the separation of investment and commercial banking and limits on the size of activities of financial firms through legislation. It believes that the losses in efficiency resulting from such restrictions and the practical difficulties of policing these nationally and internationally are not justified by any benefits.

The UK does believe that systemically significant firms ought to be more stringently regulated and that this may require mandating these firms to have higher capital and liquidity requirements. However, fearing a potential loss of its competitive position as a financial centre it has suggested that such an approach should be co-ordinated globally. It will wait for the results of ongoing discussions within the FSA, the Treasury and internationally at the FSB for criteria to identify systemic significance and plans on how to tackle such institutions including non bank financial institutions.

# **Commentary and Critique**

None of the three jurisdictions has gone for mandating a forced reduction in the 1) size 2) complexity or 3) functionality of systemically significant institutions though this is a step that many commentators feel is necessary. The UK in particular has explicitly rejected any such restrictions. The focus then is not on preventing

institutions from becoming systemically significant but on ensuring that they have a higher risk absorption cushion, more rigorous supervision and quick resolution mechanisms.

The non-separation of investment and commercial banking and the non-restriction of size through the use of antitrust or competition legislation are both victories for the financial sector lobby and a serious set-back for proponents of financial sector reform.

That having been said the US proposal is by far the best of the three and breaks new ground in several aspects.

These are: 1) It is not restricted to banks and gives the Fed the flexibility and the authority to deem any institution, including hedge funds and non bank finance companies such as GE capital as being systemically significant which automatically brings the institution within the purview of a strict regulatory regime whether it is otherwise regulated or not 2) it allows the Fed and the FSOC great scope to collect relevant information 3) It applies regulatory restrictions across the corporate structure including the holding company and not just the relevant subsidiary. 4) It applies across borders to non US firms with a US presence.

The lack of a proper proposal on systemically significant institutions in the EU stands out in contrast to what is overall a good US proposal. The UK is sitting on the fence though the fact the US proposal will be able to cover UK (and other EU) institutions but the UK and EU currently will not be able to regulate US institutions where the subsidiaries pose systemic risk in Europe may spur the European authorities into action.

# 4. Improving Crisis Handling and Resolution Mechanisms

#### US

The administration has recommended the creation of a special Bank resolution regime for exigencies where the conventional failure of a Bank may have systemic consequences. Tier 1 FHCs will be subject to prompt corrective action under the planned special resolution regime where the Fed, acting in consultation with the FSOC will be able to act decisively to close down, arrange a rescue or salvage a troubled firm so as to minimise potentially damaging systemic impacts. The Fed will have the authority to put institutions into conservatorship, receivership, to stabilize them through other means or even be able to transfer their derivatives portfolios to a bridge bank. Actions can be initiated by the Treasury or the Fed or in the case of SEC or FDIC regulated entities by these institutions.

These Tier 1 FHCs will be required to submit and update detailed plans for their winding up which will need to be approved by the Fed. The administration hopes that the more stringent regulation combined with the need to present credible wind down plans will incentivize institutions to reduce their systemic significance and simplify their legal structures. The administration plans to strengthen the firewalls between banks and their affiliates especially at the Tier 1 FHC firms.

The Fed played an important part in crisis handling by having made emergency funds available not just to banks that were eligible but also to several legal entities such as investment banks which had not been eligible under its program. The administration has recognized that this may need to happen again in a crisis so it has decided to formalize the ability of the Fed to provide emergency credit to individuals, corporations or partnerships. However, in the interest of making the Fed more accountable, this will require prior written approval of the Secretary of the Treasury.

The US authorities plan to recover the costs of financial sector bailouts from within the sector.

### EU

There is at present no significant plan in the EU on having a special regulatory regime for systemically important institutions. While the ECB has been active in crisis support, it has not gone as far as the Fed in its provision of support.

The main stumbling block is that that there are no fiscal resources to back up and pan EU action so the final authority remains with national governments. Recent discussions where the EC has been pushing hard on the need to have an agreement on burden sharing have not gone well with the likelihood of an agreement on a burden sharing formula or dedicated EU funds becoming less likely by the day.

### UK

The UK has already legislated to provide the government the power to nationalize bank holding companies where the failure of a deposit taking institution within the group would pose a threat to financial stability. It is now considering a resolution regime for investment banks. It plans to require all significant firms to have detailed wind –up plans which will for example mean that their legal structures need to be simplified to facilitate quick and orderly resolution which would help reduce the systemic risk posed by their failure. The Bank of England is to evaluate these plans. The government will also require the Financial Services Authority (FSA) to take into account the potential impact of the failure of the firm while conducting supervision and regulation.

The government has also proposed that the Financial Services Compensation Scheme (FSCS), which is used to meet the costs of paying out depositors and financing resolution costs, should be fully funded by the financial services sector itself so taxpayers are not liable. Because intervention in the financial sector can be expensive, the government believes that pre-funding the FSCS is a better approach than trying to recover the costs of the bail outs from the financial sector.

#### **Commentary and Critique**

The US proposals draw on the already operational UK proposals which in turn drew on the prompt corrective action regime that the US Federal Deposit Insurance Corporation has used successfully for several years. Both the US and UK proposals provide enormous flexibility and significant powers to the regulators and would allow the authorities to systematically take the kinds of ad hoc measures that they have had to take to help stabilize failing financial institutions and protect against systemic risk.

While the US proposal is fairly flexible the US's aversion to anything that might reek of nationalization means that the UK proposal is more broad in scope in terms of what it enables the government to do to save banks. However the US proposal has a much broader institutional scope in the sense that it allows the government to protect all systemically significant entities not just banks. A combination of a broader legal definition with more scope for depth of action including nationalization may be ideal. A serious concern raised by the US proposal is that the Fed has been given significant new powers but that the Federal Reserve System remains a private entity with a governance structure that is not consonant with such an important role. That is why the administration has also initiated a process of looking into what changes would need to be made to improve the governance and accountability of the Fed.

The UK suggestion which allows for a possible pre-funding of a rescue and compensation fund is clearly superior to the recovery of funds model that the US has put forward.

The 'making financial institutions write a living will' aspect of the resolution mechanisms in the US and the UK is very important and if stringent standards are applied this can be used to significantly reduce institutional legal

complexity (where Lehman had more than 330 subsidiaries and Citicorp more than 2400) which is a looming threat to effective regulation and financial stability.

There is an urgent need for a resolution mechanism that can operate at a pan EU level. This can happen 1) either through an institution of member state level UK like resolution regimes across all member states which are then co-ordinated or 2) by instituting a pan EU legal tool which would be best handled by the ESRB. A first step towards this (to help address the burden sharing issue) would be to impose a pan EU systemic risk levy on large cross border institutions that can be used to pre fund a EU financial stability and rescue fund. A pan EU deposit insurance levy would work well with this where all members states can be required to part contribute DI levies imposed on cross border insurance into the pan EU fund.

A critical shortcoming of the whole discussion is the total absence of a global mechanism for crisis resolution and burden sharing.

# 5. Strengthening Capital and Liquidity Requirements and Reducing Procyclicality

Given the cross border nature of many financial institutions and the competition that exists between various financial centres is it likely that strengthening capital requirements will be co-ordinated internationally. The most important body here is the Basel Committee on Bank Supervision which is responsible for the Basel accord. The FSB will also play a central role.

The discussion has four main elements 1) the amount of capital 2) the form of capital 3) the variation of capital so as to reduce procyclicality 4) the quantity and quality of liquidity buffers. The EC is likely to wait for international guidelines before moving on its intention to strengthen capital requirements and make them less procyclical. The other aspects of the discussion include strengthening capital adequacy requirements for 1) trading 2) securitizations and structured products 3) off balance sheet exposures and 4) risk enhancing compensation policies.

#### US

In addition to following the international guidelines the US government is seeking to tighten capital requirements and has initiated a working group, led by the Treasury, to conduct a fundamental reassessment of existing capital adequacy requirements by the end of 2009. It intends to apply capital adequacy requirements not just to banking subsidiaries but also at the holding company level. The US will of course also no doubt be heavily influenced by the changes suggested at the international level by the Basel committee to increase the quality and quantity of capital and reduce its procyclicality. The administration plans for all finance holding companies to be "well capitalized". The administration is also highly supportive of the ongoing BCBS work on looking at a mandated maximum leverage ratio.

#### EU

The EC has been working on revising the Capital Requirement Directive which very much remains work in progress. However, in line with the BCBS recommendations already issued in Jan 2009 some of the initiatives which have already been agreed at the EU are 1) an increase (near doubling) of the amount of capital held against the trading book 2) higher capital (almost trebling) to be held against re-securitizations and 3) a more rigorous capital adequacy regime for off balance sheet exposures. Under the CRD the EU has also already agreed to establish colleges of supervisors for (initially 44 now 40 after mergers) the largest cross border institutions operating in the EU.

Under the ongoing review of the CRD the Commission and Council are discussing 1) restrictions on how much exposure a bank can have to another financial institution (25% of its risk capital) 2) higher capital adequacy requirements in boom time 3) higher liquidity buffers. It is also intended that banks will have to stick to levels of leverage specified in a simple leverage ratio prescribed by the regulator.

#### UK

While the UK will be bound by all decisions on the Capital Requirement Directive it has been taking unilateral action and putting steps agreed at the EU level into action. The UK has already taken far reaching decisions to improve liquidity standards where it has proposed the introduction of institution specific liquidity buffers. It has also decided to introduce far more stringent stress tests for judging the adequacy of both capital as well as liquidity.

### **Commentary and Critique**

As a point of comparison it is interesting to note that Switzerland, which like the UK and Iceland has had a banking system where the assets are a multiple of the GDP, has moved fast on the issue of capital adequacy. It has doubled capital requirements to 16% in boom times and has also decided to introduce countercyclical provisions in its capital adequacy regime.

This 16% figure is likely to provide an interesting benchmark for the international discussion. The countercyclical capital requirement taken together with the existing Spanish countercyclical loan loss reserve requirements are likely to influence international discussions on reducing procyclicality in the system.

The EU's increase of trading book capital (doubling) and capital to be held against re-securitizations (trebling) as well as restrictions of exposure to a single institution (25% of capital) are also likely to provide international benchmarks.

The UK has been the first to act on the issue increasing liquidity buffers especially for international financial institutions operating in the UK which will be required to hold more 'domestic liquidity'. This too is expected to provide a benchmark though the step is controversial in some circles in the sense that it could trigger a fragmentation of the market.

On the whole, the quantity of capital seems to be moving in the right direction, the discussion on procyclicality is making slow progress and the discussion on enhanced liquidity requirements is still in its infancy partly because the focus of the BCBS as well as regulators thus far has been on capital not liquidity especially since the BCBS failed to agree on an accord for liquidity in the 1980s.

The discussion on the quality of capital also seems to be inching forward with restrictions expected on the use of many of the 'hybrid' capital instruments that were allowed over the past decade. One problem with this is that many of the capital injections by governments which have propped financial institutions up the world over are 'hybrid' in nature so requirements on beefing up the quality of tier 1 capital are likely to be introduced with a lag.

It became clear from the crisis that the capital institutions were required to hold against trading books, resecuritizations (so called CDOs and CDO Squared etc) and off balance sheet exposures to such as to SIVs (Special Investment Vehicles) was highly inadequate and allowed both a large build up of risk as well as large scale regulatory arbitrage. So there is a clear consensus emerging (as highlighted in the recently issues FSB guidelines on capital) that all of these need higher risk weighting for capital adequacy.

The discussion on mandating a maximum leverage ratio as a backstop measure is also progressing although their remain significant problems with the definition and measurement of leverage as well as the lack of an agreement thus far on what the cap should be.

#### 6. Tackling Bad Remuneration Practices

#### US

The US has appointed a 'Pay Czar' to look into remuneration practices at financial firms which the government continues to support. While outright bonus caps were rejected the administration and congress seem set to continue to look at other tools such as tax penalties to removing tax deductibility to help control remuneration practices. It also gives regulators the flexibility to issue standards and guidelines that better align compensation practices with long term shareholder value and systemic risk control. It is likely that non adherence to these will incur a financial penalty of some kind. The US has also decided to get shareholders to vote (non-binding) on executive compensation practices. Another feature of the reform is that there will be a greater independence of compensation committees as well as compensation consultants. There is also a decision to mandate a separate vote on 'golden parachutes' in the event of a merger and acquisition.

#### ΕU

Under the ongoing review of the CRD the Commission and Council are discussing imposing higher capital for banks with remuneration policies that encourage excessive risk taking (and imposing fines)

However, the EC has already rejected the idea (once being discussed) of mandating a claw back of bonuses in case the financial institution loses money but leaves open the possibility of member states imposing sanctions for risky bonus policies. The EC has adopted two (non-binding) recommendations to 1) match manager remuneration to achievement and 2) not to reward failure.

#### UK

The UK has already decided to impose higher capital requirements on firms with bad compensation practices; it has indicated that it will wait for international recommendations before embarking on further measures though it seems likely that the FSA will impose fines. The UK has already had a mandated "say on pay" non-binding shareholder resolution regime since 2002 but it is widely considered to be weak and toothless.

# **Commentary and Critique**

Despite all the public outrage and the political posturing the fact is that the discussion on remuneration remains shockingly inadequate. The recent controversy about the potential payment of a \$100 million bonus to a Citigroup trader and the resumption of colossal bonus payments by banks all the way from France and the UK to the US only goes to show how little has changed. France, which became the first large economy to implement the G-20 recommendation to curb excessive risk taking in the pay policy for traders has agreed to 1) stop guaranteed bonuses 2) link the bonus pool to overall profitability and 3) pay bonuses according to longer term performance is seeing public outrage at the disclosure that BNP Paribas which received Euro 5.1 billion from the government has set aside Euro 1 billion for its bonus pool in the second quarter of 2009 alone. The code of conduct and regulation on compensation does not capture such practices. Germany too, after public outrage has passed legislation which would forbid 'short term incentives'.

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The non-binding 'say on pay' shareholder resolutions in the UK and the US are completely inadequate not just for their non0binding nature but also because shareholder incentives are simply not aligned with controlling systemic risk.

The FSB guidelines and the planned monitoring of compensation practices by regulators are also highly inadequate. They only scratch the surface of addressing the fundamental problem of compensation design which is the inherent short term nature of incentives as well as the fundamental asymmetry that exists between good and bad outcomes. A three year stake retention means nothing when the tenor of deals is ten or twenty years. A \$100 million upside with a downside that is limited to at worst getting fired provides a clear recipe for excessive risk taking.

The proposed oversight of the risk implications of compensation practices is likely to be fairly weak for four reasons 1) the benchmark standards (as discussed in the previous paragraph) are fairly weak 2) the effective oversight is likely to be limited either to the top management and the most highly paid employees whereas the problem of bad incentives and bonuses is organization-wide 3) the enforcement mechanisms of either a higher capital adequacy or fine or both are likely to be too weak to dissuade bankers paying themselves top bonuses 4) many of the non banking financial institutions such as hedge funds are likely to fall outside the remit of the this oversight.

There is an urgent need to call for much stronger regulations on reducing the asymmetry of compensation practices and lengthening their tenor through the use of tools such as mandated bonus caps, claw back provisions, and an introduction of personal liability as well as tax penalties.

### 6. Regulating Derivatives

#### US

The administration has indicated that it would like all derivative markets to be subject to comprehensive regulation. The objectives of the legislation are 1) preventing systemic risk build up 2) promoting efficiency and transparency 3) preventing market abuses 4) ensuring that derivatives are not marketed to unsophisticated parties. The administration has also decided that the gap between securities and futures markets where futures markets are more lightly regulated than securities markets will be eliminated.

Furthermore the US authorities propose to 1) impose record keeping and mandate reporting requirements on all OTC derivatives, 2) strengthen the prudential regulation of derivative dealers which all of whom will now will be subject to federal supervision 3) require all standardized OTC derivatives to be traded in regulated and transparent venues and 4) mandate that all derivatives be cleared through regulated central counterparties. The proposal imposes higher margin and capital requirements for non standardized OTC derivatives so as to encourage standardization.

Furthermore the legislation provides for more robust margin requirements and ensures that the centralized counterparties are well capitalized. The administration has given the SEC and the CFTC the joint authority to regulate the derivative markets and has given them power to set position limits on derivative exposures especially for instruments that play a significant price discovery role.

Finally the legislation will tighten the definition of eligible investors which is expected to better protect individuals and small municipalities.

# EU

The EC, in its communication on derivatives has highlighted four main steps to bring them under greater scrutiny and regulation. The EC wants to 1) see more standardized contracts 2) mandate the set up of electronic systems of confirmation 3) require that all settlement takes place through regulated central counterparties and 4) create a central data bank to collect comprehensive information on transactions and amounts outstanding.

#### UK

The UK believes that derivatives need, as far as possible, to be standardized, liquid and have price transparency, and should be cleared through central counterparties.

### **Commentary and Critique**

All the jurisdictions are moving in the right direction in terms of 1) mandated reporting and centralized collection of all derivative exposure data 2) an increased push for standardization of products and in the case of the US on exchange trading 3) settlement of all derivative products on regulated centralized counterparties.

The US, having offered detailed legislation already is ahead of the game in terms of both the depth as well as the scope of content. The EU has refused to mandate the trading of all standardized derivative contracts on exchanges, a step the US has taken. There is a real danger here that in the absence of the EU matching this provision the US finance lobby may successfully get this watered down. They have already been opposing it strongly.

The other significant US provision is that which mandates higher margin and capital requirements for non standardized OTC derivatives so as to incentivize greater standardization. This also is a step the EU should follow.

In the EU banks and security market operators such as broker dealers were already subject to an equivalent regime unlike the US where the securities regulation was much less stringent than bank legislation. By bringing derivative market dealers under federal supervision and promising to apply tougher prudential standards the US has at least partially addressed the gap. However the EU needs to make sure now that no significant actor in the derivative market is left outside the purview of prudential oversight.

By giving the CFTC and the SEC the right to impose position limits the US has taken a significant step in the right direction provided this power is actually used. Although limited to derivatives which have a significant price discovery function it is likely that both commodity derivatives as well as credit derivatives will be covered.

The step to reduce the access that unsophisticated investors have to derivative markets will help reduce some of the most egregious abuses observed in the market.

However none of the jurisdictions have imposed pre-approval requirements for derivative products which was a fundamental ask of some of the reformers arguing for a financial product safety commission. The EU's refusal to mandate on exchange settlement of standardized derivatives could present a big problem in terms of a competitive race to the bottom with the US which might be forced to dilute its requirement so it needs to be addressed urgently. The EU should also, in line with the US penalize non standardized products so as to incentivize greater standardization. The UK, which is the largest derivatives trading centre in the world is likely to oppose imposing too strict a regulatory regime on them for fear of loss of business. Already the UK refused to along with the idea of pan European clearing and settlement mechanisms located on the continent and has nurtured centralized counterparty settlement in its own jurisdiction. The UK also helped undo the initial idea from the EC which would have seen the pan EU ESFS oversee the derivatives clearing houses.

In the US the right to impose position limits should be expanded to all derivatives, a step the EU should also follow.

Given the fractious historical working relationship between the CFTC and the SEC giving them a joint mandate is perhaps not the best idea though the formation of the FSOC might help smooth things over.

### 7. Regulating Securitization

#### US

On securitization, the US authorities have introduced flexible legislation that mandates that the originator of a securitized loan or the sponsor of securitization will need to retain a significant economic interest in a material portion of the credit risk of securitized products which has been initially set at 5%. They also intend to introduce other regulations to align the compensation of market participants with long term performance of the loans underlying the securitizations.

The administration has also given the SEC the power to increase the transparency and standardization of securitization markets and the authority to require rigorous reporting by the issuers of securitizations. It has also suggested ways to better align the incentives of brokers/originators/sponsors/underwriters and others involved in the securitization process with long term performance of the securitized assets by suggesting changes to their compensation models. The originators would no longer be allowed to instantly book profits on the sale of securities but will have to recognize these gains over time. Also, it has been suggested that fees and commissions received by loan brokers and loan officers should be disbursed over time conditional on the performance of the securities.

The legislation also makes it mandatory for rating agencies to use and make available loan level data on the assets that underlie securitized products and encourages regulators and supervisors to reduce their reliance on credit ratings.

#### EU

The EC intends to make banks retain at least five percent of the products they originate and sell on their balance sheets as a way of ensuring that they have an incentive for better due diligence and that they retain an interest in the long term performance of these products. There is also a proposal to regulate re-securitizations, which are known to be more complex than simple securitizations, more strictly through restrictions and through higher capital requirements where the capital needed to be held against re-securitizations will nearly treble.

#### UK

The UK will follow the pan EU initiatives on securitization.

#### **Commentary and Critique**

Once again the US proposal while not ideal is more detailed and seems to have a broader scope than what has been discussed in the EU thus far.

The 5% risk retention being discussed in the US and the EU is the same which reduces arbitrage opportunities but may not be large enough. There is no agreement on what an ideal ratio is and the US has given the regulators the power to tweak this and the EC will be looking into seeing whether the ratio can be increased. The US proposal allows for the risk to be retained at either the originators of the loan level (giving them an incentive

to do proper due diligence) or the sponsors of the securitization level (which gives them an incentive to make sure that the originators have done proper due diligence). It is not very clear how this option would be operationalized by the regulators. The EU proposal applies only to the banks which securitize the loans.

One of the disappointments is that none of the discussions makes a provision for restricting the issue of resecuritized products such as the now notorious CDO squared and CDO cubed which have played a central role in the ongoing crisis though the EU proposal does significantly increase the capital that needs to be held against such assets. In the absence of outright restrictions on the issue of certain kinds of securities it might make sense to link the amount of risk retention to how complex and potentially dangerous the securitized products are.

A good thing about the US proposal is how broad some of its provisions are in the sense that they are applicable across the range of actors active in the securitization chain where regulators can provide for the compensation of actors to be linked to long term performance of the underlying loans. This provision should be taken on board by the EU.

# 8. Regulation of Alternative Investment Funds (Hedge Funds, Private Equity and others)

#### US

Under current practice some advisers to private pools of capital in the US are registered with the CFTC and others register voluntarily with the SEC but the administration's new proposals will mandate registration with the SEC for all investment advisers who have more than \$30 million assets under management. These advisers will be required to report information on the 1) assets 2) leverage 3) off balance sheet exposure 4) counterparty credit risk exposure 5) trading and 6) investment positions of the funds under their management so 1) regulators can judge whether any funds pose a systemic threat and 2) are aware of all major exposures and risks in the financial system.

While in theory the provisions apply only to 'US based' fund managers the proposals use a broad definition of what such a base might be and this is likely to capture most fund managers with even a small presence in the US market (for example if they service 15 or more US clients or if they manage more than \$25 million in assets attributable to US clients or if they have a US place of business or if they present themselves as investment advisers in the US which means that most fund managers that take money from US institutional investors would be covered).

The SEC is expected to perform regular checks to ascertain compliance and forward the confidential information to the Fed and the FSOC to allow them to judge whether a fund or family of funds is so large, interconnected or complex so as to pose systemic risk. If this is the case then it will be regulated as a Tier 1 FHC by the Fed under a tough supervisory and prudential regime.

In addition to the detailed disclosures to the regulators that will be confidential the administration's proposals impose record keeping requirements and increased disclosures for 1) investors 2) creditors and 3) counterparties on the funds advised by the SEC registered fund managers.

#### EU

The EC has proposed a draft directive on alternative investment funds which will require fund managers located in the EU to register in return for being allowed to operate throughout the EU. It is intended to impose regulation on hitherto unregulated entities and imposes reporting requirements as well as conduct of business rules through entities below a threshold will be exempt (Euro 100 million for Hedge Funds and Euro 500 million for Private Equity Funds). Non EU based fund managers will have to get approval from each country where they market their

products but can apply for a pan EU passport three years after the directive is adopted once they are shown to "comply with stringent requirements on regulation, supervision and co-operation including on tax matters".

The fund managers will have to satisfy a competent authority of the robustness of its internal arrangements with respect to risk management and the security of depository arrangements. The directive intends to restrict the marketing of these funds to sophisticated investors only and intends to introduce minimum investor disclosure requirements. The directive also imposes requirements on disclosure to competent authorities regarding 1) the principal markets of operation 2) trading instruments used 3) principal exposures 4) performance data 5) concentrations of risk 6) and other details such as organizational and risk management arrangements which can allow the authority to conduct effective macro prudential oversight.

There are special requirements for reporting details on leverage above a certain threshold and there is a provision for a right of the supervisory authority to intervene in the event of perceived threats to financial stability including through mandating limits on leverage. There is also a provision for better disclosure of information by investment funds which acquire a controlling stake in a public company above thresholds of 10% and then 20% of stake.

The draft directive also provides for a 0.02% minimum capital requirement and introduces restrictions on the ability of fund managers to appoint administrators or valuers of fund assets outside of the EU.

#### UK

Under current practice Hedge Fund managers based in the UK are required to register and disclose minimum information. The FSA has said that it is working with the industry to improve the disclosure regime and get timely and relevant information including information to do with the funding, leverage and investment strategy of funds. It is planned that the authorities can request further information on a case by case basis and can also require funds to reduce leverage or unwind exposure to a particular sector if the FSA feels that it is increasing systemic risk.

However the UK government has publicly rejected large swathes of the proposed EC draft directive especially where it deals with private equity firms.

### **Commentary and Critique**

In their declaration the G-20 had clearly highlighted their intention to impose comprehensive regulation covering all financial institutions, products and jurisdictions. They intended that the largely unregulated shadow banking system of which the alternative investment funds are a part should be brought under the purview of regulation.

Both the US as well as the EU have made some progress towards this. While entities such as SIVs will be covered by new restrictions on off balance sheet exposures, the legislations proposed both in the US as well as in the EU are broad enough in scope to cover most private pools of capital including hedge funds, private equity firms, family offices, venture capital funds etc.

Both proposals take the approach of regulating fund managers not funds which may not be ideal but could work reasonably well. The EU directive, unlike the US proposal requires all fund managers to register although the details required are minimal. Above a certain size limit (\$30 million assets under management in the US and Euro 100 million for leveraged funds and Euro 500 million for unleveraged funds) there are fairly substantial registration requirements for fund managers both in the US and the EU proposals. The significantly lower US limit is much better especially when taken in the context of the ongoing EU discussion led by the UK and Sweden of removing or at least raising the de minimus exemption especially on private equity funds. The information that is

to be collected under both proposals should at least in theory be enough to be able to make judgements on the systemic risk posed by the fund.

The minimum capital requirement proposed in the EU is an interesting idea though it is simply not clear what a 0.02% requirement achieves. The US approach of being able to designate systemically significant institutions including private pools of capital as being Tier 1 FHCs and hence subjecting them to prudential supervision and regulation by the Fed is clear cut and smart at least on paper. The EU directive also on paper makes provisions for regulators being able to apply prudential standards and restrictions to alternative investment funds that are seen to be posing systemic risk but the directive provides no detail on how this might be done or who might do it. So the stated US approach to handling systemic risk posed by private pools of capital is superior.

The suggested EU passport is very good for funds which have been clamouring for something like this for a long time and it will move the EU in the direction of a more integrated financial market. But it is not clear that all national competent authorities which will regulate the alternative investment funds will possess the requisite skills and there could be regulatory arbitrage to find the most pliant regulator.

The EU requirement on needing to show robust business procedures and independent valuers is a good step but the requirement to use EU based institutions could attract retaliatory measures especially from the US which does not make a similar proposition. It might be better to specify and "equivalent regulatory regime".

The EU does stipulate (rather weak) reporting obligations on private equity funds which the US proposal does not cover.

While in headline terms the US and the EU proposals apply only to "US and EU fund managers respectively" a more detailed reading shows that the scope of the US proposal is clearly much broader. It uses a very stringent requirement which means that most foreign based fund managers with even a minimal US client base (more than \$25 million assets attributable to US clients or 15 or more US clients) will be covered by the registration requirements which is clearly superior to the EU suggestion of covering only fund managers who are actually based in the EU.

However neither of the proposals makes any reference to the market footprint of non-domiciled managers who could pose s systemic risk through their activities in the local markets even without having local offices or clients. Presumably the intention of regulators is to cover such risks under the regulation of financial markets. Another deficiency is that the US

Given the current state of the discussion it seems likely that there will be significant pressure for the EC proposal to be watered down. The UK government, the Swedish presidency and the new head of the finance and monetary affairs committee at the European Parliament have all made statements to this effect. Given the strength of the private sector lobby there would also be pressure to water down US proposals. However the real controversy in the US is likely to arise when the Fed starts designating some of these pools of capital as Tier 1 FHCs and regulating them as such.

# 9. Credit Rating Agency Reform

### US

The US authorities having recognized the role that Credit Rating Agencies played in the crisis have made detailed proposals that focus primarily on more stringent regulation tackling conflicts of interest and increasing openness.

The administration's proposals have introduced a compulsory registration requirement for CRAs and a dedicated office at the SEC for supervision as well as oversight of ratings methodology.

They 1) bar firms from providing consulting services to any firms they also rate 2) prohibit or at least mandate disclosure of conflicts of interests arising from a wide array of relationships 3) mandate disclosure of fees paid for each rating as well as fees paid by the client over the past 2 years 4) will require look back due diligence in case an employee is hired by a client in order to make sure that there had been no improper conduct 5) make disclosure of 'ratings shopping' compulsory 6) require a separate ratings scale for structured products 7) mandate detailed qualitative and quantitative disclosures to accompany all ratings 8) make compulsory the disclosure of detailed information on structured products to all agencies so they can provide unsolicited 'independent and unsolicited' opinions.

In addition to these proposals the administration has initiated two reviews by the President's working group on financial markets and the Government Accountability Office on how to reduce the use of credit ratings in regulation and also launched a public consultation on the subject.

#### ΕU

The European Council and the Parliament have already agreed to proposals put forward by the EC on the regulation and supervision of Credit Rating Agencies in the EU. The agencies will be required to register with the pan European Securities regulator (CESR for now) and will then be supervised by colleges of national securities regulators. It is anticipated that the ESFS will play a central role in the regulation and supervision of these agencies when it comes into existence. The supervisor will set up an information repository which collects information on the methodology, performance and data of all ratings issues by all the ratings agencies. This repository will help do due diligence and benchmark performance.

The CRAs will be required to 1) have at least two independent board directors whose compensation is not linked to the performance of the firm 2) disclose the names of rated companies which contribute 5% or more to their earnings 3) rotate their analysts regularly so they do not get too close to any industry 4) Besides, the commission plans to impose rules on ratings agencies such as disclosure of the models and methodologies on which they base their ratings. Furthermore the commission has suggested that it would require the agencies to improve their governance standards including for example by having at least two independent board directors whose compensation is not linked to the performance of the firm.

In addition to this CRAs will be forbidden to rate companies where analysts have financial interest and forbidden from providing consulting services to firms they rate now or in the future.

### UK

The UK has not made a separate proposal on ratings agencies and is bound by EU rules.

### **Commentary and Critique**

There are a few big solutions to the problems highlighted in credit ratings in the current crisis. One of them is to shift from the current 'issuer pays' model to a 'investor pays' model. Another is to eliminate the regulatory role enshrined for credit ratings. The third is to tackle the pervasive conflicts of interest, information asymmetries and problems inherent in boiling complex risks especially in structured products into a single number.

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Regulators have rejected the first because of the practical difficulties of implementing this. Regulators around the world but especially in the US are looking seriously into reducing the role of credit ratings in regulation but it seems highly unlikely that this role can be eliminated altogether.

The focus of most new regulation then has been on the third option of minimising conflicts of interests and reducing information asymmetries. Here both the US and EU proposals are far from perfect but present significant steps in the right direction. Moreover, the proposals could benefit from cross fertilization.

In particular the US proposals on the disclosure of detailed analysis to supplement ratings as well as the mandatory pooling of data to other agencies should be taken on board by the EU. In turn the data repository suggested by the EU as well as the compulsory rotation of analysts should be taken on board by the US.

In summary, though these proposals represent progress of some kind they simply do not go far enough. Another easy to implement idea where part of the funds paid by the issuer are pooled into a fund which chooses a second rating agency at random (or according to some other well thought out criteria) to produce an independent rating would improve incentives and outcomes. The information produced in this way could be used to spot and tackle discrepancies, perform due diligence, monitor accuracy and track records and take corrective action.

#### 10. Improving Consumer (and Investor) Protection

#### US

The administration has proposed setting up a new Consumer Financial Protection Supervisor to solely to protect consumers of credit, savings, payment, and other consumer financial products and services and to regulate providers of such products and services. It is proposed that the agency will be independent, have a broad jurisdiction over all legal persons covered by its mandate and have the sole rule making authority on consumer financial protection. The idea is for the agency to provide a floor with states retaining the ability to enshrine more rigorous consumer protection measures.

As part of the consumer protection reforms the principles of 1) transparency 2) simplicity 3) fairness and 4) access will be stressed in regulatory and supervisory efforts. The CFPA will emphasize tackling abusive credit card practices, mandating simplified disclosures, instituting a duties of care requirement for mortgage brokers and banning side payments to remove conflicts of interest.

The US authorities also intend to improve investor protection by giving expanded powers to the SEC in investor disclosures and by establishing a fiduciary duty for broker dealers and investment advisors towards their clients. There is also a proposal to expand whistleblower protection, expanding sanctions and requiring non binding shareholder resolutions on executive compensation plans.

Finally, the US plans to set up a Financial Consumer Co-ordinating Council with a broad membership of the federal and state consumer protection agencies under the aegis of the systemic risk council. It also plans to define a permanent role for the SEC's Investor Advisory Committee.

#### EU

The Commission recently put out a communication on packaged retail products which sets out a commitment to deliver improvements to investor protection measures for the main investment products bought by retail customers. It will prioritize the provision of simpler, improved and coherent product information. For example the CESR has already published the details of a synthetic indicator which on a scale of 1 to 6 will highlight the risk

inherent in retail products. The commission is trying to draw on current best practices prevalent in different jurisdictions and across different product lines and bring then together.

Fundamentally though consumer/investor protection in the EU continue to fall under national domains where the requirements and enforcement varies widely. However, there is an ongoing discussion on how existing provisions under the MIFID as well as a review of the Market Abuse Directive could be used more effectively across the EU.

The commission has also launched a consultation on responsible lending (and borrowing) wherein it plans to look into 1) the advertising and marketing of credit products 2) pre contractual information and assessing credit worthiness 3) advice standards and the 4) registration, licensing and supervision of credit intermediaries.

### UK

The government intends to raise financial decision making capability in retail consumers including through the provision of a national money guidance service. It also intends to improve access to simple and transparent products so that there is always an easy to understand option for those not seeking sophisticated products.

The UK also intends to find better and faster ways of dealing with widespread complaints, for example by increasing the Financial Services Authority's (FSA) power to impose a settlement and by allowing groups of consumers to seek collective redress.

As a way of increasing consumer choice and reducing prices, the government has adopted an explicit aim to strengthen competition including through more co-operation between the FSA and the Office for Fair Trading (OFT). It plans to use these agencies to promote market access for consumers and will also look at the possibility of using new technologies to encourage new entrants and promoting competition. It also seeks to maintain a strong role for the mutually owned financial sector in order to ensure diversity.

#### **Commentary and Critique**

There is a real danger that with the primary focus of regulatory reform discussions being on tackling systemic risk and financial stability the discussion of consumer protection and investor protection might get short shrift. In fact the discussions are linked. Improper controls mortgage origination lay at the heart of the problem of subprime loans. Unscrupulous practices by credit intermediaries also seem to have contributed to excessive borrowing by consumers.

Moreover the erosion of consumer and investor confidence in the operation of financial markets can both cause as well as amplify financial instability. This loss of confidence can come from two sources – systemic risk and its associated asset price falls and an erosion of belief in the integrity of markets and market participants. While the crisis was triggered by systemic risk the uncovering of unscrupulous practices by the likes of Bernie Madoff helped amplify it. The sale of inappropriate products as 'certificates' to German Investors and exotic derivative securities to investors in Hong Kong did not help matters.

Once the crisis broke, the overleveraged retail consumers (mortgage holders as well as those who have borrowed on credit cards) have borne the brunt of house foreclosures as well as usurious credit card interest rates.

In this context the Obama administration's proposal for a dedicated consumer protection agency seems well placed especially since the agency will have equal status to the prudential and market integrity regulators and will have a set at all the important regulatory tables including within the Financial System Oversight Council.

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The idea of centralizing all consumer and investor protection functions within the agency is also an excellent idea especially because consumer protection is often given less of a priority within regulatory agencies that also have responsibilities for prudential regulation or supervision. Moreover the powers vested in the agency seem to be broad enough in scope to allow it to have real teeth.

However, it is also a proposal that has attracted a lot of opposition especially from within the financial services industry which is likely to fight tooth and nail to get the proposal diluted.

While for structural reasons getting an equivalent agency in the EU would be trickier there is a strong case to push for a dedicated agency under the ESFS. This is especially important since the consumer and investor protection available in different member states differs substantially. A second best solution would be to get EU wide legislation (which we already have pieces of in directives such as MIFID and MAD) which provides a floor or minimum standard on consumer and investor protection.

The Commission's new communication on packaged retail instruments and the consultation on responsible lending are encouraging and need to be strengthened.

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