

SYMPOSIUM REPORT

BUILDING THE FINANCIAL SYSTEMS OF THE
21ST CENTURY:
AN AGENDA FOR EUROPE & THE UNITED
STATES

APRIL 3-5, 2008
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The sixth annual Europe-U.S. Symposium was held at the Weill Center in Armonk, New York as the subprime crisis continued to unfold. Discussions at the Symposium occurred in the context of continuing concern about the U.S. and global economies, as well as uncertainty about the ultimate effects of the ongoing subprime crisis. Two sessions addressed global financial stability, one from the perspective of the impact and control of the liquidity and credit crises and one from the perspective of new regulatory approaches and principles. The third session considered new principles for regulation of international financial transactions, including selective recognition and the EU model.

**Session I: Global Financial Stability Revisited—
The Impact and Control of the Liquidity and Credit Crises**

A central concern among all the sessions was to better understand the ongoing crisis. In Session I, participants actively discussed its core and proximate causes, its current status, and how it should be handled in the short term. Longer-term solutions were addressed in Session II.

What Went Wrong? Macro-Level Causes

Participants put forward a variety of macro and micro-level explanations of what had created the crisis. They generally agreed that no single cause or actor could be identified; rather, they pointed to a confluence of conditions that had led to excess liquidity, lax lending standards, and overconfidence. There were, however, significant differences of opinions regarding which factors had been most important, which led also to some disagreement regarding how the crisis was likely to play out and what roles regulators, central banks, and financial institutions should play in addressing the crisis.

Excess Liquidity

There was widespread agreement that one of the key factors that contributed to the crisis was excess liquidity in the years leading up to it. A number of participants were critical of the actions of central banks, particularly the Federal Reserve under former chairman Alan Greenspan for having overreacted to the bursting of the tech bubble and 9/11.

Two versions of the criticism were put forward. One was that excessive attention to price stability had come at the expense of ignoring asset prices, and that the rapid rise of low-cost imports from China and other emerging markets had disguised the deleterious effects of the build-up of excess liquidity. Other participants were more sympathetic to monetary policy makers, arguing that it would be irresponsible to base monetary policy on asset prices rather than general price levels. While they agreed that price stability did not guarantee financial stability, they felt that it was probably a necessary condition and that the pass-through from asset prices to the real economy was too unstable to be the basis for monetary policy.

The other critique of Fed policy focused on asymmetrical responses to changes in asset prices (sometimes called the “Greenspan put”). In this interpretation, the Fed and other central banks had become too sensitive to the negative effects of downward moves in asset prices and too forgiving of the negative effects of upward moves. Therefore, the monetary policy

framework had developed a built-in upward bias, which encouraged financial institutions to discount the likelihood of severe crashes of major asset classes.

Significantly complicating matters was the generally deflationary effect of China and other emerging markets. As a number of participants noted, many market actors – not only central bankers, but also investors of various sorts – believed that globalization and other factors had created a fundamentally benign monetary situation and reduced concerns about excess liquidity.

Products

Participants noted that, as in previous financial sector crises, the combination of easy money with new financial products created an atmosphere in which risk was significantly underestimated. Part of this underestimation was seen to derive from a lack of understanding on the part of many investors of how some of the new financial products worked. More fundamentally, however, many pointed to the belief that new financial products and modeling capabilities had allowed risks to be much more effectively spread across financial actors and better hedged within financial institutions' balance sheets than ever before. This confidence contributed to the willingness of financial institutions to accumulate staggeringly large gross liabilities through derivatives, leveraged loans, and the like.

There was considerable discussion about what it was that had made the subprime mortgage-backed securities particularly toxic. Two broad, non-exclusive themes dominated that discussion. One focused on the underestimation of risk of the underlying mortgages – either due to poor underwriting standards or to an unwarranted expectation that real estate prices would continue to rise. Participants felt that there had been widespread surprise when repayment rates fell to levels that threatened returns on mortgage-backed securities, leading to major pullbacks by investors even from senior tranches. This effect was strongest in the subprime mortgage-backed securities and in more junior tranches, where liquidity dried up quickly.

The other theme of discussion addressed the role of structured financial products that seldom if ever traded, even when there was a deep market in the underlying assets. Many participants expressed skepticism about keeping such products on trading books. They also noted that the lack of markets in such products forced investors to rely on mark-to-model to price the assets on their balance sheets. This proved to be a major problem when funds were forced to try to sell the assets, creating an artificially large drop in their value.

Contagion

Participants appeared to be universally surprised by the speed with which the crisis impacted financial institutions' balance sheets, with Bear Stearns cited as a particularly extreme example. Most participants agreed that rapid contagion was the result of a combination of excessive concentration of risk, heavy leverage, and insufficient collateral in a number of financial institutions and funds. When counterparties made margin calls or reassessed their willingness to lend to institutions with deteriorating asset quality, they were forced to try to liquidate the assets; given their illiquidity and a loss of confidence in pricing models, this led to precipitous drops in their market value, forcing further margin calls, further price drops, and further unwillingness of counterparties to lend.

Participants recognized that the problem of contagion was not just across financial institutions with holdings of subprime mortgage-backed securities, but across financial products as well. A major pathway for this contagion was through the asset-backed commercial paper market. As suspicions grew about the underlying assets and the creditworthiness of issuers, demand dropped. This in turn led to a significant contraction in funds for leveraged buy-outs and for debt generally, as well as rapidly rising spreads for credit default swaps.

Finally, there was discussion about contagion into the real economy. One point that many participants made was that the evaporation of significant capital from the financial system would inevitably force a contraction in lending. Several estimates were offered as to the likely size of the overall credit contraction, ranging up to nearly \$5 trillion. While some participants expressed hope that healthy financial institutions would continue to receive capital injections from sovereign wealth funds and other sources so that a severe credit crunch might be avoided, most felt that the days of easy money had passed.

It was also noted that deteriorating conditions in the U.S. mortgage markets were already leading to significantly more stringent conditions for potential borrowers. This appeared to be particularly the case in subprime, but also was reverberating more broadly. Refinancing in particular was noted to be more difficult, as lenders had begun to demand significantly greater equity before extending loans; given the combination of significant increases in loan-to-value ratios in recent years with declining house prices, far fewer home owners would be in a position to refinance. While there was general agreement regarding the phenomenon itself, there was less consensus as to whether its effects would be positive or negative. On the negative side, there were fears of a deepening recession. Other participants saw the situation in a more positive light, however, arguing that the U.S. model of debt-financed consumption was not sustainable in the longer run, and that increasing caution by lenders would be a stabilizing factor in the economy.

What Went Wrong? Micro-Level Causes

Participants also discussed at length some of the micro-level factors that had contributed to the problem. The fundamental concerns raised had to do with information and incentives.

Management of Information

Participants paid a great deal of attention to the management of information. In looking at the causes of the crisis, key themes included transparency and overconfidence in the ability to measure risk.

There was some debate over the quality of transparency and disclosure in the financial sector. A number of participants argued that legal requirements for transparency and disclosure had been quite rigorous and that the quality of information had been less of a problem than how that information had been used. They pointed, for example, to the fact that the major systemic effects had arisen not from the least regulated financial institutions, such as hedge funds and private equity, but rather from the banks. Others were more skeptical, arguing that while there had indeed been significant quantities of information available, it was not available at a granular enough level, leading to a significant underestimation of risk.

Another major concern over transparency prior to the crisis had to do with off-balance sheet assets and funds, many of which ended up returning to the home institutions either because of contractual obligations or reputational concerns. Either way, many participants

agreed that off-balance sheet assets and transactions had turned out to be more an exercise in disguising risk than in reducing it.

This led to considerable discussion regarding how various actors had made use of the information that was available. In this regard, even as many participants emphasized the role of macro-level factors and contagion in the difficulties being faced by financial institutions, others noted that the effects varied considerably by institution. A number of them argued that this was the result of variations in risk management and practices of due diligence. Three major criticisms were leveled regarding financial institutions' risk management. First was over reliance on quantitative models and rating agencies to estimate balance sheet risk. Several participants argued that these models – particularly for new derivative products such as subprime mortgage-backed securities – lacked robustness because they were based on insufficient data. It was also pointed out that they significantly underestimated correlation risk across various assets. Others acknowledged the problem, but expressed frustration that their honest efforts at following robust and sophisticated risk management strategies had been overwhelmed by events, and wondered whether any system of risk management could adequately address the challenges of rapid changes in financial markets. A second criticism was that, in their enthusiastic acceptance of quantitative risk modeling, financial institutions had neglected the fundamental asymmetries of information among various actors; as in the first criticism, the apparent precision created by models and stress tests led to unwarranted confidence in the information that underlay them. The third major criticism had to do with the internal structure of financial institutions. Many participants expressed concerns about the “silo problem,” worrying that it may have become impossible to fully manage the risks across large-scale financial conglomerates – in other words, that scope actually prevented effective risk management instead of allowing for better diversification across business areas.

There appeared also to be widespread agreement that many financial institutions had been lax regarding due diligence, both toward products in which they invested and toward counterparties. Several participants argued that the lack of prior due diligence led to an overreaction when it turned out that there were greater risks attached to many derivative products than previously believed. Some felt that such an overreaction had been an issue in the Bear Stearns collapse.

Actors, Incentives, and Capabilities

Participants connected several of these problems to incentive structures for various actors in the system. They argued that there was a necessity to restructure incentives throughout the financial system, both at institutional and individual levels. Among the actors considered in this regard were loan originators and securitizers, rating agencies, investors, traders, and regulators.

An issue that concerned many participants was the deterioration in quality – and often outright deception – in many subprime loans, particularly after 2005. While some blamed investors for not carrying out due diligence or for misunderstanding the assets they were purchasing, there appeared to be a general consensus that skewed incentives for loan originators had contributed to the profusion of poor quality mortgage loans. They pointed out that originators made money by maximizing new loans, particularly those with attractive characteristics such as high spreads and prepayment penalties; however, since they often did not hold onto any of the debt themselves, they did not face the downside risks of such risky loans. While participants agreed that this incentive structure should be changed, there was no consensus as to how best to do so – for example, while some suggested that originators could

be forced to retain a portion of their loans, others countered that easy access to various derivative instruments would render such a requirement meaningless.

The role of securitizers was considered as well. A number of participants argued that securitizers faced a similar incentive structure to originators – i.e., that they made money on volume and transferred most of the risk to investors. Others disagreed, on one or both of two counts. First, they pointed out that securitizers typically held onto the riskiest tranches of the securities they created, so they did carry some of the downside risk. Second, they questioned just how far due diligence should extend – after all, originators and rating agencies had given their professional assessments and had certified that the loans conformed to relevant regulations and standards.

Rating agencies came in for considerable criticism, with a particular focus on the incentives facing U.S. rating agencies. It was noted that agencies had made a great deal of money on rating various asset-backed securities, and that this market had been an extremely attractive one for them. Many participants agreed also that conflicts of interest had arisen from the fact that agencies had not only provided ratings for securities, but had also provided fee-based guidance to securitizers on how to improve the ratings for their securities. Finally, there appeared to be a general consensus that the basic fact that rating agencies had been paid by suppliers rather than customers created an obvious conflict of interest. A number of participants argued that an overhaul of regulation of ratings agencies would likely be a key part of any effort to address the issue over the long term through regulation. A number of European participants, meanwhile, argued that the rating agency issue was more of a U.S. problem than a generic one. They pointed out that in Europe there was much less concentration of agencies, and that multiple business models prevailed among them. Moreover, they stated that European financial institutions had traditionally been much less reliant on rating agencies than U.S. institutions, both because of the predominantly wholesale nature of investors and because of differences in the interpretation of capital adequacy standards.

Meanwhile, participants questioned why investors had apparently so underestimated (or underpriced) risk. Much of the focus was on the effects of global excess liquidity in the context of high savings in emerging markets and relative price stability. With money easy to come by, investors of all sorts increasingly chased spread wherever they could find it. Several participants pointed in particular to the incentives created by compensation structure at hedge funds as driving this risk appetite. A number of participants went further, suggesting that in general incentive pay at financial institutions should be linked more to long-term performance, rather than being based only on end-of-period positions.

Finally, there were questions about the ability of regulators to understand and manage markets that had exploded in terms of both size and complexity. Concerns included regulations and accounting standards had allowed many financial institutions to create corporate structures in which regulators could not fully determine their overall risk exposure, insufficiencies of supervisory manpower or expertise, and deficits in international coordination.

Restoring Confidence

While participants vigorously discussed the various causes of the current crisis, the major practical issue raised in Session I was the question of how financial institutions, central banks, and regulators should manage the crisis in the near term. In the end, much of this discussion came down to the question of how confidence in the financial system could be restored.

Confidence was defined in several non-exclusive ways. For financial intermediaries, confidence in counterparties was seen by many participants to be a necessary precondition for return of liquidity to a variety of short-term markets and an end to excessive volatility in those markets. Other participants focused on investor confidence, arguing (1) that once markets had established a floor price for distressed assets, risk capital would reemerge, and (2) that only when financial institutions had fully exposed the extent of their losses and potential losses from the crisis would they be able to carry out the necessary recapitalization needed to allow credit to expand once more. For central banks, participants described a dilemma between providing liquidity in order to create confidence that they would act decisively to prevent worsening of the crisis, on the one hand, and the need to assure markets that crisis management efforts would not destabilize market confidence by raising fears of future inflation, on the other.

A key question for financial institutions was how de-leveraging and de-risking would occur. With upwards of \$500 trillion in gross outstanding derivatives in world markets, it was noted that de-leveraging could take a considerable period of time and that potential for panic selling remained. In the end, many participants argued, the key element for many affected financial institutions would be recapitalization, which would provide a buffer to avoid panic-selling of assets and would be reassuring to counterparties seeking to reduce risk. This would inevitably mean that cash-rich financial institutions would need to reenter the market to acquire stakes in affected institutions. In this regard, a number of participants noted the importance of sovereign wealth funds in the recapitalizations to date; others also pointed to private equity and other funds that had been amassing investment capital to reenter the market. While a few participants raised the specter of possible government-funded recapitalizations in the future, participants by and large agreed that private-sector recapitalization would be preferable and was indeed the likeliest outcome.

Some participants focused on the role of transparency and disclosure, topics that came up repeatedly in all sessions of the Symposium. In this case, the focus was on full disclosure of losses and risk exposure. These participants argued that a key element of lack of confidence was in fact uncertainty; thus, disclosure of information to counterparties and investors would be indispensable in persuading them to do business with or invest in any given financial institution. More broadly, full disclosure by all global financial institutions would be necessary to regaining confidence in financial markets generally. Participants saw major roles for self-regulation and market discipline in pushing forward such disclosure, rather than focusing only or even primarily on regulation.

The final issue, for which there was no clear consensus, was the appropriate role of central banks in supporting liquidity and market confidence. There were two lines of discussion, both of which hinged on the issue of time inconsistency. First, while most participants appeared to agree that assertive policies by the Fed and other central banks had helped to stave off much more serious contagion from episodes like the Bear Stearns failure, others cautioned that such actions risked recreating the "Greenspan put" and leading to moral hazard. The opening of the discount window to investment banks made many of these participants nervous; discussion in Session II considered more closely what might be an appropriate regulatory *quid pro quo*. Second, there were serious concerns over the possible acceleration of inflation, particularly in the United States. This was seen as particularly dangerous at a time of rising inflation globally. In this regard, many participants drew a distinction between liquidity support and monetary policy, arguing that the former would be appropriate but not the latter. With regard to monetary policy, there were also questions as to whether lowering interest rates could stimulate the economy in the context of financial sector confusion; some argued that it would actually be

counterproductive if it lowered confidence by raising inflationary expectations or by further weakening the dollar. (It was generally assumed that the ECB was much less likely to fall into this trap, partly because of its exclusive focus on price stability and partly because conditions in Europe were seen to be far less precarious than in the United States.)

Session II: Global Financial Stability— New Regulatory Approaches & Principles

Looking to the future, participants discussed the role of regulation in supporting efficient financial markets, reducing the likelihood of future crises, and improving future crisis management. These discussions sought to draw lessons from the analysis described above, while also grappling with the new regulatory reality that had been created by assertive actions by the Fed and other legal and prudential regulators in the midst of the current crisis.

Regulation and Crisis Management

Extending the discussion from the first session about how to restore confidence, participants considered several aspects of current crisis management. They looked not only to the role of regulators, supervisors, and central banks, but also to the role of the private sector. Indeed, there was deep concern that, in a desire to show commitment to solving the problem, regulators and supervisors might act hastily and impose unnecessary and long-lasting costs on the industry.

Coordination among Regulators and Supervisors

A concern among many participants was about the ability of regulators, supervisors, and central banks to work together within and across borders in an effective manner. A number of participants pointed to the example of Northern Rock as a cautionary tale, noting that despite the highly consolidated nature of UK financial regulation and supervision, the BOE and FSA were unable to coordinate effectively to prevent bank failure.

Seeing how difficult effective coordination was even in the UK, some worried how feasible it would be in a highly fragmented system such as the United States. Others felt that coordination had been surprisingly effective. To some extent, this reflected the fact that systemically important institutions tended not to be regulated by states, which reduced the level of supervisory fragmentation (other than for large insurance companies). Also, many participants noted that the Fed had effectively taken the lead, using its lender of last resort function to expand its role as prudential supervisor.

Issues of international coordination were also of great concern to many participants. Although they noted with approval the extensive and multi-layered dialogue among U.S. and European regulators, supervisors, and central banks that had developed over a period of years, they worried that there was no explicit framework for dealing with the failure of internationally active financial institutions, other than the principle that home country supervisors would take the lead. While many participants agreed that this was a useful basis for cooperation, they expressed uneasiness about whether home country officials would necessarily act in the best interests of all stakeholders.

Some participants also raised more specific concerns. For example, what if there were a failure by a major financial institution based in a small economy in which authorities had limited supervisory competence? Conversely, if the failure of a large institution based in a major economy were to have large-scale impacts on a small or emerging economy, would efforts to manage the failure address those impacts? (In this regard, the question arose of who would be part of the coordination process in addressing a major multinational financial institution. It was agreed that only major country and EU officials would be at the table in such a case.) And even

within Europe, differing deposit insurance regimes and bailout policies could lead to politically charged results if a bank with branches in several different countries were to fail.

Role of Central Banks

Given the centrality of the Fed's role in handling the financial crisis in the United States, there was considerable discussion of the appropriate role of central banks in crisis management, as well as the long-term implications of actions taken in the midst of a crisis. Participants wondered not only if the Fed was getting it right, but also whether there were general lessons to be derived from its actions.

The Bear Stearns episode was on the minds of many participants. Some questioned why counterparties and creditors had moved so quickly to remove their support, and suggested that if only liquidity had been available Bear Stearns might have remained solvent. They also questioned how the Fed had determined its willingness to guarantee up to \$29 billion in debt, while brokering an apparently very attractive deal for J.P. Morgan. However, many participants expressed deep relief that the Fed actions had restored confidence, saying that the situation could easily have set off much more widespread panic without such assertive action.

Regarding general lessons, a major focus was on provision of liquidity. Participants had a generally positive perception of the liquidity provision efforts of the Fed, BOE, and ECB. Although some were skeptical that liquidity initiatives could be fully segregated from monetary policy, they agreed that assertive central bank actions had prevented interbank and other short-term markets from seizing up and thus significantly reduced contagion.

Some specifics of the Fed's liquidity provision efforts created unease in the minds of some participants. One of these was the Fed's willingness to accept relatively risky securities as collateral for swaps and repurchase agreements. A number of participants worried about how the Fed would price them and whether it was adequately accounting for the risk. At the extreme, it was pointed out that the Fed could theoretically need to be recapitalized if worse came to worst. More generally, it was seen by some to raise the likelihood of losses; in this sense, they suggested it could lead to less Treasury revenue and an increased need for taxation, despite lack of Congressional debate.

A more controversial aspect of Fed liquidity provision was the decision to open the discount window to investment banks. While recognizing that some investment banks held the potential to pose systemic risk both domestically and internationally, many participants were uncomfortable with the idea that institutions that were not subject to as stringent regulation as commercial banks would receive the same sort of institutional support. Not only did they see it as unfair, they worried that it would be precedent-setting, which posed two additional problems: how to prevent moral hazard among the Fed's potential new discount window clients, and where to draw the line between eligible and ineligible institutions. Additionally, there was a sense that the Fed would need to establish clear guidelines for kinds of collateral it would accept in its transactions with non-traditional discount window users.

In order to avoid moral hazard, participants agreed that, in exchange for ongoing access to the discount window, it would be necessary for the Fed to take on new oversight roles. There was, however, not a consensus as to what those should be or how widely access to the discount window should be extended. Some participants felt that new discount window clients should be expected to meet the same general standards as commercial banks, while others worried that this would lead to overregulation and a stifling of innovation. At the very least,

however, there was a consensus that any institution borrowing from the discount window should have the same reporting obligations, so that the Fed could reasonably be able to judge whether the institution was solvent and whether a failure would pose a systemic threat. Participants noted approvingly that the Fed had been able to take on this de facto prudential supervision function on a contractual basis in exchange for access to the discount window.

While some aspects of the U.S. experience – such as the expansion of market liquidity facilities – appeared to hold general lessons, participants saw the expansion of Fed oversight as peculiar to the U.S. regulatory structure. They felt that U.S. regulatory fragmentation and in particular the lack of a competent prudential supervisor essentially forced the Fed's hand. In other words, no one else was doing the job (the SEC lacked capacity) and no one else could; only the Fed had both the expertise and a legal means of forcing compliance and disclosure without the need for new legislation. In the European context, they saw fewer gaps and clearer lines of authority. Several participants wondered whether it made sense for oversight of large, systemically-important financial institutions to be separated from the lender of last resort function. Some saw lessons in European practice, which combines both functions in the national central banks.

Role of Private Sector

While much of the discussion about crisis management focused on central banks and other official actors, participants agreed that the role of the private sector would be equally important. Several industry group representatives pointed to redoubled efforts to set up codes of best practice and other schemes to improve self-regulation. However, most of the focus was on the actions of individual financial institutions and on market discipline.

The key point for many participants, as already noted in the summary of Session I as well, was the importance of full disclosure of losses and risk exposure by individual financial institutions. Several participants argued that financial institutions should not wait for new standards to be articulated by regulators, but should act quickly and assertively to provide quality information that would reduce the uncertainty facing counterparties and potential investors.

Valuation of Assets

While the general importance of disclosure was universally agreed upon, however, a number of participants expressed uneasiness with applying the principle of mark-to-market in the midst of a crisis. Their concern was two-fold. First, in a crisis, distress sales and panic selling can force the market price of illiquid assets down far below its actual value. Second, mark-to-market has pro-cyclical effects, which could contribute to a downward spiral in asset prices and conceivably lead to unnecessary failures of financial institutions.

Other participants were skeptical of attempts to reconsider mark-to-market. At one level, they thought it irresponsible to talk of changing valuation standards in the midst of a crisis, arguing that the most important aspect of crisis management was to maintain a stable regulatory setting. (In one sense, some noted, it was a moot point, in that the EU's acceptance of IFRS meant that European regulators were not in a position to alter the requirement on their own anyway.) They also expressed concern that any substitute for mark-to-market would have the effect of reducing transparency and common standards, even if it only applied in periods of constrained liquidity.

Skeptics on changing mark-to-market offered two solutions for how financial institutions should deal with illiquid assets. Some argued that illiquid assets should not even be on trading books, given how little they trade. The more common suggestion was that financial institutions should hold more capital if they have a significant portfolio of illiquid assets or if mark-to-market could potentially have a very large effect on their capital adequacy in a crisis. Some participants asked in this regard whether Basel II should be changed. While most felt that was a longer-term prospect, a number of participants argued that banks should be taking their self-regulation obligations seriously and should be upping their capital – as indeed a number of leading international banks had been doing in recent months. Others expressed concern that raising expectations for bank capital could have pro-cyclical effects that would reduce profitability.

What Not to Do

Finally, participants agreed on several principles that they felt should guide the regulatory response to the crisis. Most importantly, they warned against overreacting to the crisis by instating excessive regulation of financial markets. Rather, they felt that markets were generally self-correcting, and that regulation should be aimed at facilitating self-regulation and eliminating distorted incentives. Several participants argued that it hardly made sense to legislate major new changes in regulations that had not even been fully implemented yet. They also worried that there would be enormous pressure to put into place long-term solutions in the midst of the crisis, and that this was likely to lead to ill-considered policies. There were also serious concerns that politicians would be tempted to seek national solutions that might be protectionist in nature. Thus, there was a strong consensus that any new regulatory requirements should contribute to continued openness of national markets and be created in the context of international consultation.

Long-Term Solutions: Structure of Regulation

Moving beyond the short term, participants discussed at length how regulation and oversight should be structured so as to support innovation and efficiency of financial markets, reduce the likelihood of future crises, and improve coordination of crisis management. Participants addressed general principles as well as specific issues in the U.S. and European contexts.

Where Are the Gaps?

A nagging concern of many participants was where the next crisis might arise, and whether it might result from gaps in regulation and oversight. In the current crisis, some participants argued that gaps in coverage of investment banks and rating agencies (particularly in the United States) had contributed to conflicts of interest and the emergence of systemic risk from their actions. These participants generally applauded efforts to improve investment banks' disclosure of information and agreed that regulation would be needed to change rating agencies business models to better align their incentives with those of the markets. There was also a general consensus that market discipline should be the centerpiece of crisis prevention and management. For some, this meant that additional regulation should only be imposed to strengthen disclosure to investors, creditors, and counterparties.

Another regulatory gap that was addressed by some participants was hedge funds and private equity firms. Given the intense concern expressed among many observers about the effects of large unregulated pools of capital, some participants were reassured by the fact that they neither triggered the crisis nor created systemic problems in cases where they failed.

Several participants attributed this to market discipline – either that their incentives were properly aligned or that the unregulated nature of those institutions had encouraged lenders and counterparties to evaluate the risk associated with them much more carefully. Others suggested that the relatively good performance of large unregulated pools of capital in the current crisis might also be attributed to luck, and that there could be no guarantee that they would not trigger the next crisis.

There was similar ambivalence about sovereign wealth funds. Participants agreed that some sovereign wealth funds had played a constructive and stabilizing role. However, there was still some uneasiness about the level of transparency regarding goals and operations, particularly given predictions about the likelihood of their continued rapid accumulation of assets into the future. Several participants looked approvingly to efforts to create codes of conduct for sovereign wealth funds, but worried that problematic investment practices could contribute to a future crisis.

How Should Roles Be Allocated? Paulson Plan and General Principles

The recent publication of the U.S. Treasury's Blueprint for a Modernized Regulatory Structure ("Paulson plan"), combined with the experiences of Northern Rock and Bear Stearns, prompted participants to focus their attention on how the roles of official actors should be allocated. Participants agreed that the Paulson plan should not be understood primarily as a way of addressing the current crisis, despite its inclusion of short-term priorities. Beyond that, however, there was considerable disagreement as to whether it would create more effective oversight or be politically feasible.

The general principles raised by the Paulson report and financial institution failures had to do with the relationship among various regulators. While European countries do not face the kind of extreme fragmentation found in the United States, where federalism has dictated a significant role for individual states and institutional history has meant division even at the national level, Northern Rock did create some concerns among participants about the division of labor even in the UK.

The main principle that was discussed was whether it was optimal to separate prudential oversight and lender of last resort functions. In fast-moving situations such as that of Bear Stearns, it was suggested that no regulator other than the lender of last resort could have managed the crisis. In the case of Northern Rock, concerns were raised by some participants about the quality of coordination between BOE and FSA. Others, however, argued that the core problem was the impossibility of providing "stealth" liquidity, since depositors, investors, creditors, and counterparties had rapidly lost confidence in the bank when its resort to the discount window became public. (A similar point was made with regard to the Fed's attempts to prevent similar runs as a result of its own emergency liquidity provision operations.)

With regard to the Paulson plan itself, opinions were mixed. While most applauded the effort to consolidate regulatory responsibilities in a smaller number of national-level organizations, others questioned whether it went far enough, noting that although it defined three separate categories of agencies (market stability regulator, prudential financial regulator, and business conduct regulator), it actually envisioned five different actors. Moreover, it left intact the crazy-quilt of state regulators and supervisors, relying primarily on a federal opt-in mechanism to encourage financial institutions toward more consolidated regulation. A third concern was that the plan focused excessively on organizational structure, and much less on content of regulation (although it did make some general statements about the usefulness of

principles-based regulation and the need to eliminate distinctions between various types of financial institutions). For example, some participants expressed concern that a merger of the SEC and CFTC might reduce flexibility in regulation of derivatives markets by extending a legalistic model of regulation and oversight across the board. Finally, some participants cautioned that whatever the organizational plan and formal intent of the blueprint, the nature of interactions among the regulators would be a key to its success in preventing and managing crises.

Defenders of the plan argued that it would be a vast improvement over the current situation, and that a unitary financial regulator simply would not be feasible in the U.S. political context. They stated that coordination among even four or five agencies would work much more smoothly than the current situation. Participants also appeared by and large to be supportive of the significantly enhanced role of the Fed as “market stability regulator.” In part, they felt that the Paulson plan would have the effect of cementing the de facto expansion of Fed responsibilities that had arisen in the current crisis, which appeared to have had positive effects on market stability.

Moving away from the merits of the plan, many participants questioned the political feasibility of the Paulson plan. They predicted widespread resistance by state regulators and some industry and consumer groups, and argued that it stood little chance of succeeding on its own terms. Others were more optimistic, predicting that the extent of the crisis meant that legislators would have to consider fundamental reforms in the system of U.S. financial regulation. The Paulson plan, they argued, was well-timed to help set an agenda for reform that would be sufficiently ambitious to address major problems while also remaining market-oriented and internationally open.

Can Europe Deal with the Failure of a Cross-Border Financial Institution?

A final issue that arose regarding coordination among regulators and central banks was whether the European system could effectively manage the failure of a financial institution with significant cross-border activities. It was agreed that the principles of cross-border crisis management were clear: regulatory and lender of last resort functions would be up to national authorities of the financial institution’s home country, while deposit insurance (in the case of bank failures) would be managed locally within each country in which the bank did business.

Despite the clarity of jurisdictions and responsibilities, a number of participants expressed concern that the actual resolution of a financial institution might be much more complicated. Several participants worried that while the current system made sense for financial institutions with business operations primarily in their home countries, home-country regulators would be hard-put to deal with the legal and economic ramifications of the failure of a large global or regional financial institution. They wondered whether it might become necessary for EU-wide institutions (especially the ECB) to play a larger role in coordinating and managing resolution of such situations.

The other concern was over lender of last resort functions. It was noted that the current framework expects national central banks to take responsibility for lending into crises. The dilemma, however, is that while the lender of last resort function is left with national central banks, only the ECB can create Euro. While the ECB has no formal authority to act as lender of last resort, it may have to do so anyway. If a national central bank were to incur losses in carrying out the lender of last resort responsibility, the national treasury would be on the hook; several participants questioned whether it would be politically viable or even fair in some cases

to localize these costs in the home country instead of socializing them across the Eurozone through ECB action.

Other Issues

Several additional issues arose in Session II, including how to define moral hazard in the context of financial institution “bail-outs” and the role of emerging markets not only in the current crisis but also in preparing to deal with ongoing issues and future crises.

There was considerable discussion over how to define moral hazard in the context of rescue packages such as the Bear Stearns deal. On one side, some participants argued that as long as shareholders were punished with loss of equity, such rescue packages would not introduce moral hazard into the system. They reasoned that shareholders would understand the need to monitor the activities of financial institutions, and thus impose sufficient discipline. Most participants disagreed with this limited vision of moral hazard, however. They argued that unless creditors and counterparties were also subject to losses, there could not be meaningful market discipline.

The role of emerging markets came up at several points during the Symposium. Participants remarked that, although in the last several global crises emerging markets had been sources of instability, in the current crisis they had actually been forces for stability. Not only had they been far less affected by the crisis due to a far more cautious approach to subprime mortgage-backed securities and illiquid derivatives in general, but investors from the emerging markets had also been an important calming influence on developed country markets through their role in providing funds for recapitalization.

Although emerging markets had been relatively unscathed from the crisis so far, participants worried that this was not necessarily due to better regulation and oversight. Meanwhile, their continued rapid growth meant that emerging market financial systems and financial institutions were also becoming systemically more important. As a result, there was a strong feeling among many participants that it would be essential to involve emerging market regulators more intimately in the global processes of convergence and coordination. In this regard, there was some concern that the established pattern in which U.S. and EU (and to a lesser extent, Japanese) regulators set global standards and best practices may need to be amended.

Session III: New Principles for Regulation of International Financial Transactions (Selective Recognition, EU Model)

In Session III, participants stepped away from the current crisis to look at opportunities to lower barriers and transaction costs for cross-border transactions between the United States and Europe. It was noted that the removal of intra-EU barriers and clarification of regulatory and supervisory responsibilities had already contributed significantly toward moving Europe in the direction of a true single market in finance. Thus, the major focus was on transatlantic processes.

Discussion centered around the interaction of financial globalization with national regulation and the question of how to manage differences in national regulatory and enforcement regimes. Participants agreed that regulatory differences would need to be managed along the three tracks of standardization, recognition, and exemption. Additionally, participants paid considerable attention to political issues of jurisdiction, mutuality, and relations between regulatory agencies and legislatures.

Standardization

Participants agreed that a basic principle of managing the needs of global finance was convergence of regulation and enforcement; however, they also recognized that sovereign prerogatives and institutional path dependence would mean that significant national differences would persist. For this reason, they focused on means of promoting functional equivalence among U.S. and EU regulatory and enforcement regimes. While much of the discussion in Session III focused on mutual recognition and exemptive relief, participants saw some level of standardization as a prerequisite to both.

The main focus of discussions about standardization was on creating clear definitions by which functional equivalence could be determined. Participants reasoned that with clear definitions, it should be relatively easy to resolve technical differences where different regulators were actually operating on the basis of common principles. Several also felt that dealing with these technical issues could be seen as the “low-hanging fruit” in international regulatory convergence, and might provide an impetus for further improvements.

Two types of definitions were put forward as particularly useful and relatively tractable. One was the distinction between wholesale and retail (or as some participants preferred, sophisticated versus unsophisticated) investors. Participants agreed that having a common definition of who is a wholesale investor would be a prerequisite to moving forward on reducing barriers through either recognition or exemption, due to the existence of differing legal protections for and political sensitivity toward retail investors across jurisdictions. While many assumed that it should be relatively easy to create a common definition, however, others were more cautious, pointing out that there might often be a practical distinction among large investors, wholesale investors, and sophisticated investors. They argued that it would be important to achieve a common understanding as to which types of investors needed less protection before choosing a definition.

The second set of definitions focused on disclosure. Participants applauded the SEC decision to allow foreign firms listing in the United States to use IFRS without reconciliation. Nonetheless, they felt that the job was not yet complete, and called for EU acceptance of US GAAP and for the SEC to offer U.S. firms the continued opportunity to use IFRS for their domestic filings. A few participants questioned whether Congress might choose to get involved

and potentially slow down the process of standardization, but expressed hope that ongoing SEC actions to recognize IRFS would constitute a *fait accompli* and lock in standardization.

A final set of issues regarding standardization had to do with venue. First, while participants saw standards as operating ideally at the global level, many agreed that the EU and the United States had the opportunity to take the lead in establishing high-quality global standards. With the vast majority of global financial activity being carried out by European and U.S. financial institutions in either the United States or Europe, any mutual decisions would become de facto global standards and offer a model for emerging market regulators. (However, a number of participants cautioned that it would be important to maintain communication and take into account the concerns of emerging market regulators and financial institutions.) Second, while most of the discussion concentrated on official-level efforts, several participants pointed out the potentially important role of financial institutions, exchanges, industry associations, and sovereign wealth funds in setting common standards and best practices. Improved self-regulation and codes of conduct could, they argued, both reduce the burden of responsibility on regulators and also provide templates for them to follow in their own international deliberations.

Recognition

Given the practical limits on, global harmonization, much of the discussion in Session III focused on recognition of regulatory and enforcement regimes as the best possible solution to continuing transatlantic barriers. The implicit model for many was the intra-EU principle of recognition of home country rules, although it was recognized that enforcement was still left to host countries.

Comparability of Regulatory and Enforcement Regimes

While many participants saw recognition – particularly mutual recognition – as the best available solution to reducing barriers, they also recognized a variety of technical, legal, and political problems. One key hurdle would be designing a rational framework for comparability assessments.

Participants agreed that the principle behind comparability assessments was clear: functional equivalence. They also agreed that complications quickly arise when trying to create a clear framework. There was considerable concern, however, about how to create a clear baseline for comparing EU principles-based and U.S. rules-based regulation. (In this context, it was suggested that the rules issued under MiFID could provide guidance for an analysis of comparability with the United States.)

Finally, it was noted that there has been significantly more regulatory convergence regarding wholesale markets than in retail. Thus, most participants agreed that recognition would work only if it were selectively focused on wholesale financial markets and sophisticated investors, rather than across the board. This highlighted again the importance of standardizing and clarifying definitions of different types of investors both transatlantically and across asset classes.

Participants also agreed that there were a host of legal and technical challenges in moving forward on recognition, although these were not discussed in detail for the most part. One key challenge that some participants highlighted, however, was information sharing. Effective and ongoing information sharing would be essential to maintaining a viable recognition

agreement. However, differing privacy laws and other obstacles to transfer of financial information to foreign regulatory and supervisory agencies remain; at least some of these would require legislative action to fully address. There were also questions about what kind of legal recourse would be made available to investors operating across borders, as well as which courts would have jurisdiction.

Political Considerations

Beyond the economic and legal aspects of recognition, participants spent considerable time discussing more political aspects. These included issues of reciprocity, scope, and choice of negotiating partners.

The issue of reciprocity focused on the question of whether recognition should be mutual or unilateral. Participants agreed that governments have a general preference for mutual recognition over unilateral recognition, reflecting the market access component of recognition regimes; however, they disagreed on whether this was the correct approach. A number of participants argued that insisting on mutuality of recognition could slow progress and end up emphasizing issues that were more political in nature than focused on the economic benefit. Unilateral recognition, they emphasized, would allow for comparability assessments to be carried out on the basis of objective criteria, which would allow recognition to be extended to a broader set of economies much more quickly. Other participants objected to this line of reasoning. They argued that states whose systems had received unilateral recognition from a partner would be able to protect their financial institutions by foot-dragging; this would damage both the economic interests of home-country financial institutions and exchanges and the political standing of the agency that decided to extend unilateral recognition.

There was also some discussion regarding the appropriate scope of recognition, although in the end there no disagreement regarding the short to medium term. While participants agreed that in an ideal world, recognition would cover the full range of financial services, they also agreed that at least initially any recognition regime would have to be selectively focused on the wholesale market. Looking further into the future, many participants felt that some of the most lucrative markets would be in retail, but they were less confident that the differences could be ironed out. One set of participants argued that convergence pressures even in retail finance would be strong, especially as wholesale markets become increasingly integrated. Others, however, felt that the differences between the United States and Europe in terms of the politics of protecting retail investors and their systems of legal recourse would be very difficult to overcome even well into the future.

A final set of political questions regarding recognition focused on choice of negotiating partners. Participants discussed the U.S. decision to begin mutual recognition talks with Australia and Ontario, and what the impacts might be on U.S. mutual recognition talks with Europe. More pointedly, they discussed at length the question of which European entities would be able to negotiate mutual recognition with the United States – did the European Commission have exclusive competency, or could individual states take the initiative to open their markets to U.S. financial institutions and exchanges through a process of mutual recognition?

Two main explanations were offered for why U.S. regulators had chosen to start with Australia. One was that, given the novelty of recognition pacts for U.S. regulators, it made sense to start with a relatively small, relatively similar market with a single regulator with which to negotiate. This would allow U.S. regulators not only to “pick up a win,” but also to learn by doing before turning to more consequential European markets. An alternative point of view was

U.S. authorities might be interested in starting with smaller markets where they could wield America's massive market power. Having established precedent in those markets might help to influence any U.S.-European arrangements. The precedent issue concerned a number of participants, who worried that it would make U.S. negotiations with European authorities more difficult or contentious.

More contentious was the question of negotiating competency within Europe. Participants agreed that the United States would only be willing to negotiate mutual recognition with selected European economies such as the UK, where enforcement regimes could truly be said to be comparable. Forcing the inclusion of less well-developed financial regimes in a U.S.-European mutual agreement pact would be a deal-breaker. For some participants, however, this practical concern collided head-on with EU prerogatives. They argued that "cherry-picking" would be legally and politically unacceptable, and that individual states could not enter into negotiations or agreements without the participation of the Commission. The principle on which European states would make their judgment on this issue was unclear. Some argued that it should be dealt with as a market access issue and thus agreements that affected any one EU member must apply to all. Others countered that recognition was not really a market access issue but an assessment that financial markets and actors would be protected in an equivalent way; since enforcement regimes are organized on a national basis in Europe, they argued, national authorities are the proper negotiating partners. Given the uncertainties involved, there appeared to be general agreement among participants that bilateral negotiations between the United States and European countries would not proceed until there had been a clear signal from the Commission on this matter. It appeared likely that the Commission would at least need to come up with a legal framework and set of constraints

Exemption

In recognition of the potential difficulties of even selective recognition between the United States and European states, a number of participants advocated more expansive use of exemptive relief, such as under SEC Rule 15a-6. The discussion of exemption in Session III touched on issues for broker-dealers of timing, fairness, and division of responsibilities between supervisors.

Many participants viewed exemption favorably, describing it as a second-best solution that is faster and more flexible, albeit more limited and piecemeal, than recognition. They pointed out that exemptions could be decided unilaterally based on objective criteria. Moreover, because in practice they are limited to specific activities by specific firms, they avoid the political problems inherent in judging the competence of enforcement by other governments. Some participants also suggested that, by providing concrete examples of effective enforcement of cross-border activities by wholesale actors, expanded use of exemptions could contribute to greater convergence of enforcement and business practices. (There was, however, some skepticism that the exemption process itself could be standardized across countries.) A final benefit that some participants noted was that exemption could sidestep the "cherry-picking" problem that complicated the progress of mutual recognition, in that exemption decisions are under the jurisdiction of national authorities in Europe. They noted that a few key European markets, including the UK, already had provision for exemption, and expressed the hope that others would follow suit.

Other participants objected – in some cases strongly – to the generally positive depiction of exemption. The biggest objection was over fairness. It was pointed out that, although exemptive relief (especially Rule 15a-6) is often presented as a neutral assessment of the

abilities of a given financial institutions in a given line of business, in fact it only covers certain types of activities. Most egregiously, they argued, it tends to privilege broker-dealers, which are eligible for 15a-6 exemption, over exchanges, which are not. European exchanges are thus unable to compete with broker-dealers in attracting cross-border transactions by offering U.S. access to trading screens or even by directly informing U.S. investors about equity products. Thus, even if expanded use of exemptions were to prove to be a step toward broader mutual recognition, they worried that exchanges would not be able to make up for the broker-dealers' headstart.

Several other concerns were raised with regard to fairness and efficiency. It was noted, for example, that due to the CFTC's greater willingness to provide exemptive relief through no-action letters, U.S. investors were already able to invest directly in foreign futures but not their underlying assets. Regarding efficiency, a number of participants argued that the ad hoc nature of exemptions has reduced their attractiveness. The current practice, particularly in the United States, grants financial institutions exemption only for specific types of transactions; thus, for any given transaction, financial institutions must state their eligibility. Some participants complained that there was not even a centralized clearinghouse for information regarding which financial institutions have been granted exemptive relief on which transactions, adding significantly to complication and paperwork. Politically, a number of participants expressed concern that excessive focus on exemption as a stop-gap measure would take attention away from efforts to push mutual recognition, and might even lead to complacency in pursuing that larger goal.

The final set of issues discussed under the rubric of exemption pertained to how enforcement would be shared. Some of the same issues were seen to apply to recognition as well. While the basic principle of exemptive relief was agreed to be home-country regulation, participants expressed uncertainty as to how far that extended. For example, there was confusion as to whether home or host country conduct of business rules would apply. There were also questions about remedies for investors – again, would this be done through the home or host system? Some participants suggested that one way out of these ambiguities would be to focus on designing private enforcement rather than relying on court processes that could be highly legalistic or even have conflicting interpretations of home and host responsibilities. However, there was also some skepticism that this could provide an across-the-board solution, even though it could be useful in some situations.

Politics of Cross-Border Regulation

Finally, in addition to the issues already noted, participants brought up several political concerns. As in Sessions I and II, there was considerable discussion of the impact of the current crisis, and whether it constituted a window of opportunity for improving the efficiency of regulation of cross-border transactions or carried the threat of overregulation and reduction of international cooperation.

One major political concern was over protectionism. In addition to the possibility of protectionist legislation or political pressures on regulatory agencies regarding standardization, recognition, and exemption, some participants raised the prospect of judicial extraterritoriality. They worried that, whatever regulators may agree to regarding legal recourse, there was no guarantee that a U.S. court would not claim jurisdiction in a civil or criminal case. This possibility compounded more general concerns expressed by participants about the costs imposed by lawsuits in the U.S. system.

A final political consideration had to do with EU decisionmaking. As noted above, a number of participants expressed optimism that U.S.-EU agreements could create effective global precedents for openness and high-quality regulation. However, others worried that, because it was so difficult to achieve intra-EU agreement on rules, intransigence would result and there would be little prospect for reopening agreements to achieve compromises even with the United States.