Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States
Rüschlikon, Switzerland • February 27-March 1, 2002

Wednesday, February 27, 2002

18:30-19:30 Cocktail Reception (Foyer, Level 3)

19:30 Dinner in Dining Room (Villa, Level 1)
Greetings:
John Fitzpatrick, Chief Financial Officer, Member of the Executive Board, Swiss Reinsurance Company
Hal S. Scott, Nomura Professor & Director, Program on International Financial Systems (PIFS), Harvard Law School
Philip Wellons, Deputy Director, Program on International Financial Systems, Harvard Law School
Keynote Address:
Andrew Crockett, General Manager, Bank for International Settlements

Thursday, February 28, 2002

07:00-08:30 Breakfast Meeting of Panelists, Facilitators, and Reporters (Villa, Level 1)

08:30-08:40 **Welcome & Opening Remarks** in Forum (Pavillion, Level 3)
Markus Diethelm, Chief Legal Officer & Head of Group Public Affairs, Swiss Reinsurance Company
Hal S. Scott, PIFS

08:40-09:00 **Session 1: Pension Reform** in Forum (Pavillion, Level 3)
Panelist: Charles Alexander, President, GE Capital Europe
Panelist: Zvi Bodie, Professor of Economics and Finance, Boston University

09:05-10:25 Small Group Sessions in Seminar Rooms 2-5 (Pavillion, Level 4)

Group	*Room*	*Facilitators*	*Reporter*
A	5	Brandon Becker & Markku Pohjola	Eric Morgan de Rivery
B	4	Timothy Caverly & Alfred Steinherr	Phil Wellons
C	3	Ronald Freeman & Axel Siedenberg	Hal S. Scott
D	2	Schuyler Henderson & Lars-Erik Kvist	Rolf Nebel

10:25-10:40 Refreshment Break

10:40-11:10 **Session 2: International Disclosure Standards** in Forum (Pavillion, Level 3)
Panelist: Hal S. Scott, PIFS
Panelist: Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies

11:10-12:20 Small Group Sessions in Seminar Rooms 2-5 (Pavillion, Level 4)

Group	*Room*	*Facilitators*	*Reporter*
A	5	Markus Diethelm & Mario Giovanoli	Eric Morgan de Rivery
B	4	Gregor Pozniak & Mark Slaughter	Phil Wellons
C	3	William Blair & Peter Tils	Hal S. Scott
D	2	Steven Kaempfer & Tim Ritchie	Rolf Nebel

12:30-13:30 Lunch in Dining Room (Villa, Level 1)
Keynote Address:
Philippe Maystadt, President & Chairman, Board of Directors, European Investment Bank

13:30-15:00	**Session 3: Fighting Economic Crimes Against the International Financial System** in Forum (Pavillion, Level 3)	
	Panelist:	Hans-Peter Bauer, Chief Risk Officer, UBS Switzerland
	Panelist:	Richard Newcomb, Director, Office of Foreign Asset Control, United States Treasury
	Panelist:	Richard Small, Director of Global Anti-Money Laundering, Citigroup
	Panelist:	Peter Wallison, Resident Fellow, American Enterprise Institute
15:00-18:30	Free time	
15:00-17:00	Reporters (from Small Group Sessions) Meeting	
18:30-19:30	Cocktail Reception in Reception Area (Pavillion, Level 4)	
19:30	Dinner in Dining Room (Villa, Level 1) **Keynote Address:** Susan S. Bies, Board Member, Board of Governors of the Federal Reserve System	

Friday, March 1, 2002

08:00-09:00	Breakfast Meeting of Discussion Chairmen and Steering Committee (Villa, Level 1)	
09:00-09:50	**Presentation & Discussion** in Forum (Pavillion, Level 3) **Pension Reform**	
	Chairman:	Chris Huhne, Member of European Parliament
	Chairman:	Ronald Logue, President & Chief Operating Officer, State Street Corporation
	Reporter:	Philip Wellons
09:50-10:20	**Presentation & Discussion** in Forum (Pavillion, Level 3) **Fighting Economic Crimes Against the International Financial System**	
	Chairman:	John Fitzpatrick, Chief Financial Officer, Swiss Re
	Reporter:	Eric Morgan de Rivery
10:20-10:35	Refreshment Break	
10:35-11:30	**Presentation & Discussion** in Forum (Pavillion, Level 3) **International Disclosure Standards**	
	Chairman:	Guido Ferrarini, Professor, Centre for Law and Finance
	Chairman:	Robert Strahota, Assistant Director, Office of International Affairs Securities & Exchange Commission
	Reporter:	Hal S. Scott
11:45-13:30	Closing Lunch in Foyer (Pavillion, Level 3)	

REPORT: 2002 Symposium on Building the Financial System of the 21st Century: An Agenda for Japan & the United States
Rüschlikon, Switzerland, February 27 – March 1, 2002

I. Pension Reform

Pension systems are time bombs, armed and ticking, particularly in Europe. No participant questioned the need for reform. According to participants, there is a fairly good understanding of what is essential to build a strong pension system. The political process is the stumbling block. Participants tended to agree about the necessary substantive policies and debated instead the process of reform.

Pension reform is a big subject, the literature is vast, and its many dimensions vary by country. Against this backdrop, participants in the Symposium raised and discussed topics they saw as key for Europe and the U.S. Much of the value of this discussion lay in the topics participants identified as significant.

The topics included the purpose of pension reform, the relation between the pension system and the economy, the need for transparency and consumer understanding of the pension system, changing the balance among the three pillars, the government role in the pension system, the problems of diversifying savings portfolios, and the need for portability. The following sections describe the discussion of each topic. Cutting across these topics are various themes, such as the long time it takes to accomplish reform.

A major theme of the discussion was how pension reform must reshape expectations. One example was the conventional expectation that a pension system provides the income after workers retire. This is far too simplistic, said participants. Even today, and particularly in much of Europe, the word "retire" generally means that one stops work, usually at a common age, such as 55 years. But this increasingly misdescribes what happens. People may leave full time jobs at about 55 only to switch to a new full or part time regular job or consulting for ten years or longer. With a life expectancy of 85-90 years, they need an income to provide for the many years remaining after age 55. This suggests that a pension system must take a view on the role of work after formal retirement as well as the payments the retiree receives as pension. For this reason, participants said that it is necessary to redefine expectations about work as well as retirement.

The purpose of pension reform

Participants identified three progressively broader goals of pension reform. It could:

1. Give workers an opportunity to accumulate tax advantaged long-term savings for their needs when they retire. Here each person targets a level for income after retirement and is primarily responsible for achieving it. Defined contribution schemes are an example.
2. Provide a minimum living standard, or level of welfare, for retired workers. Here the big debate from country to country, as described below, is about the level of this minimum standard. Defined benefit schemes are an example.
3. Provide retired workers a minimum level of benefits, such as health benefits like Medicare, in addition to the minimum living standard.

The tension among participants was between #1 and #2. Participants did not discuss #3 in detail.

Pension systems and the economy

Pension systems affect the economy. Participants noted that pension reform can reduce risk for workers, freeing them to be more productive, or it can undermine productivity by mis-structuring incentives. Pension reform can help to amass savings for use in productive ways. A failure in the pension system may threaten the economy. The loss of long-term savings by large groups of people could reduce current consumption, for example, dramatically slowing economic growth. Participants recognized these macro-economic effects of pension reform without trying to explore them. The debate at the Symposium about pension reform was how to allocate the fruit of production among workers today and workers from the past, not how reform can increase the size of the pie.

Transparency and consumer understanding

Lack of transparency and limited consumer understanding create serious problems for reform, said participants. Most non-professional consumers find the pension system opaque. This can scuttle useful reform in two ways. Opacity undermines both the efforts to reform the pension system and the effectiveness of the reforms once they are made.

Transparency and understanding are poor because the subject is complex and technical and, for the majority of workers who do not face retirement soon, remote. First, to come to grips with the need for reform today, people must understand the weaknesses of the current pension system, its alternatives, demographic forecasts, and fiscal analysis. The core problem, noted by many participants, is that changing demographics make the high post-retirement living standard supplied now by many government pension systems impossible for the government budget to sustain and difficult for private systems to approximate. Participants said that many Europeans now expect pensions to provide a very high share of wages earned close to retiring, perhaps as much as 85% of their highest working income. In contrast, Americans were said to expect a lower percentage and, therefore, accept a lower standard of living at retirement. Expectations of a high living standard in retirement make change both essential and very difficult politically. People do not want to give up what they are "entitled" to. Ignorance about the problems of the current system dovetails with short-term self-interest to stall reform.

Second, to accept and adapt to reforms that give individuals much more responsibility managing their pension assets during and after their career, people must understand pension arrangements, how they work, and the choices they present. Workers investing their funds must understand a complicated financial system that offers a bewildering array of choices and risks. The direction of reform is to place greater demands on workers and retirees, said the participants.

As senior experts in the field of finance who know the intricacies of markets, the participants were acutely aware of the limited financial knowledge and skill of most people. Participants said that the issues demand a level of knowledge and skill that does not exist now. Yet the reforms make these people responsible for managing their own financial assets.

Simple reliance on financial advisors does not offer a solution, some participants said. The financial advisor's job is to present the choices clearly. Advisors, however, too often fall short of this standard. For example, a participant reported that financial advisors perpetuate myths, such as the idea that the risk of equity investments declines over the long term. These must be debunked and the advice upgraded. But this improvement alone is not sufficient.

What is to be done? For reform to occur, the voting public must come to see the need for change on broader fronts than simply the technical issues. The voters who now see a pension as an entitlement should see, instead, a need to contribute to and share in the productivity of the economy. Voters need to become willing to protect weak groups, such as future generations who have no voice now, against the power and immediate demands of workers approaching retirement. They need to accept that their country must let immigration increase to offset declining birthrates. For the long term, in which people accept responsibility for managing their retirement assets, they must learn the basics about the pension and financial systems.

How can voters and beneficiaries be reached? Participants struggled to find the right balance between public relations, which is a tool for reform in the near term, and education, which could prepare people to manage the new pension systems.

Better public relations is essential. For public relations to succeed, the pressing challenge is for politicians to make pension reform exciting to the electorate, said one participant. A majority must vote for such things as compulsory contributions to pension savings and a reduced government role. But the transition will take a long time, as described below, so public relations work alone is not sufficient, said others.

Education to raise the limited financial literacy of the public takes generations, said participants. People must learn how to manage their pensions. In the U.S. today, the youngest generation of workers confronts a wide array of choices about how to hold the assets set aside for their pensions. They will learn to manage these assets over time. Generations of workers before them did not have this range of choice, if they had any choice, said participants, and so did not build the essential skills. Most European workers also lack experience and skill. Their education must start early.

Where must this be done? Participants said that Europe has the more serious problems. Although populations will age on both continents, they will age faster in Europe than the U.S. and in Europe the working population will decline, while in the U.S. it will grow. In Europe, there are two levels of political decision making, national and transnational. The advent of the euro increased the role of the EU relative to national governments, and the latest draft of the EU pension fund directive ("EU draft Directive") begins to reinforce the trend. Participants pointed out, however, that the brick walls hit by pension reform are at the national level, not in the EU.

Very basic policies – such as the relative importance of the three pillars – now require change country by country.

The three pillars: changing the balance

Participants discussed the appropriate mix in the role of government, employers, and individuals providing for, and managing, pensions. These are commonly presented as the three pillars of a pension system:

Pillar 1: social security pension schemes (compulsory, public)

Pillar 2: occupational pension schemes (privately run, based on collective agreements or voluntary contracts between employer and employee, or unilaterally promised by the employer)

Pillar 3: private pension schemes (individual pension plans)

Although the debate is sometimes presented as a choice between either compulsory public schemes or private schemes, no participant argued for eliminating a pillar. No one asserted, for example, that the government role should completely end. No one insisted that the employer should have sole responsibility. What if, participants asked, the employer does not exist in 20 years when many employees retire? No one proposed to rely only on voluntary systems. Every country has poor people who cannot afford to save enough and need help.

Participants recognized that the transition to more balanced use of all three pillars from arrangements that rely now almost entirely on the government is essential in much of Europe and well underway in the U.S. In the U.S., private pensions account for almost all new personal savings and already produce about 20% of income for the elderly.

Participants debated whether the latest EU draft Directive adequately addresses this matter. In one view, even such a basic question as whether all EU states should provide for employer retirement schemes is not answered, since some members oppose them. The draft is general, lacking the specificity of other EU directives, such as for capital adequacy. It leaves too much to regulators at the national levels. Others said the draft sets principles, as it should, leaving it to the member governments to realize the principles.

Although the EU draft Directive is a very small first step toward change, the EU leaves the transition to member countries, so change will occur at very different speeds. Private pensions are already high in the Netherlands and Denmark, and they have grown in importance in the U.K., which has made major reductions in the government's role as a provider. In most of the rest of Europe, however, private pensions play a minimal role. Italy and Germany have made some important reforms. Germany, for example, provided in 2001 for defined contribution plans through voluntary contributions of up to 1% of gross earnings. France has been among the slowest to change. The result is that participants see harmony of policy toward the 3 pillars in the EU countries a long way off.

In Europe, participants acknowledged, the transition will be expensive, take decades, and be difficult to manage. It takes a very long time for expectations about the government's dominant role to change. In the U.S., it has taken 30-50 years to change expectations. The generation now in retirement expected government to play a major or even an exclusive role as provider of pensions. The generation now about 50 entered the workforce expecting a defined benefit plan but has come to accept defined contributions. The generation just coming into the U.S. work force expects to be largely responsible for its own pension. Europe should expect an equally long transition.

The transition to greater self-reliance requires the country to manage expectations down. Some countries offer lessons for doing this. The U.K. succeeded in getting people to expect little from the government and reduced the government's pension liabilities by 50% of GDP. One lesson was that countries making the transition should not over-sell the private pillars. For example, they should not promise a 10% annual return on investment, which is political dynamite when it fails to materialize. Germany's 2001 reforms provide a long time to phase in (from 7 to 29 years) and government gives workers incentives to join private pension schemes voluntarily. But some participants doubted that any single country's experience offers a good model. Over 30-40 years, they said, the policies of even the most lauded – Chile, the Netherlands, or Sweden – have not really worked well.

On-going changes in the structure of employment may speed the transition. The job market is swinging back to relatively more self-employment, said participants. One can take a long view since the problem is long term. According to one participant, jobs in agricultural economies were not the employer's or government's responsibility. But with industrialization, people looked to companies and then the government for work. It may have seemed natural for workers to rely on these employers for adequate pension benefits. Now, however, a growing portion of the workforce is self-employed, at least in the U.S.. This will help them see their pension benefits as much more their own responsibility.

Closely related is the future role of pay-as-you-go (PAYG) systems. The assertion that PAYG is obsolete and should be completely abolished did not find much support. PAYG refers to any unfunded system, public or corporate. Participants recognized that PAYG systems will not be able to meet their obligations alone in the future, given demographic changes reducing the size of the workforce relative to the pensioners. The deficits are so large that, if the government steps in to meet them, the fiscal impact would be devastating. Participants argued, therefore, for reducing PAYG's share to a minimum. But participants did not agree about the size of transition costs. In one view, the high costs of moving from PAYG are lower than the costs of sticking with PAYG, which has a lower rate of return than funded systems. In another view, the transition costs may be so high that there is no clear direct economic rationale to make the move. But even in this view, the secondary benefits, such as the impact of the change on savings, investment, and growth, justify greatly reducing the relative role of PAYG. Over the long run, the question is who will bear these costs, which weigh so heavily on the generation that bears them that the political fallout is daunting. Perhaps the participants' idea to keep PAYG, but at a minimum, will lower some of the political roadblocks.

Government role in the pension system

Despite the need for the other pillars to grow in importance, the government will continue to play an important role in the pension system, as a regulator as well as a provider of funds. As a regulator the EU, said some participants, urgently needs to decide a basic issue – who is responsible for the regulation of asset allocation – and make the rule uniform across Europe. It needs to promote diversification and portability, as described below.

The role of the government as provider came under closer scrutiny by participants, who asked:

1. Should government assure some minimum level of payment to retired workers?
2. If so, what should be assured? To whom?
3. Should the government guarantee private pension schemes?
4. How should the guarantees be treated in the national budget?

These are questions for national governments. Participants did not expect the EU to resolve them soon for the all its members.

The obligation of government to assure some minimum level of payment to retired workers is, and will continue to be, very different in the U.S. and Europe. Participants noted that the social contract differs between the two regions. In the U.S., unlike many European countries, people do not expect the government to meet a substantial part of a retiree's needs. In the U.S., the government's role is to assure many private sector workers a right to income that is a relatively small dollar amount in the form of Social Security rather than a high fixed percentage of final salary. Americans debate whether workers have a right to invest funds themselves, taking the risk and reward, or instead whether the Social Security should make the decisions. The Enron collapse highlighted these issues.

By contrast, European governments, subject to a more demanding social contract, must assure retirees of higher payments. On the Continent, the obligations of government to people of working age are now much larger in proportion to the economy than in the U.S.. These existing obligations affect people's expectations and limit the government's ability to pull back from its major role providing pensions after people stop working. In many countries of Europe, compared to the U.S., the public sector employs a much larger share of all workers. The government gives unemployment and other benefits to a much larger share of people in the workforce. The French government, for example, employs or gives welfare benefits to about 50% of the workforce. European countries vary, of course. The U.K. government has much less responsibility than the French, for example.

If government should assure a minimum level of payments, what is the right level, how old should people be to receive it, and should it be available to all people or just the poor? As described above, the level in continental Europe is high and unsustainable. No participant offered a new lower level as an alternative. As to whether the benefits should be paid starting at age 55, 65, 70, or some other age, participants agreed that full retirement at 55 is no longer feasible. They recognized that delaying the age when payments begin will reduce the claims on the government. They favored flexibility. People in good health should not stop work just because they turn 60, for example.

The question of who should receive the government's minimum payments is usually presented as a choice between all people or only the poorest, but participants saw this as simplistic. They noted the special category of people who are not poor in their working life but become pension poor at retirement. This could happen for several reasons. One group may simply never have built their own pensions. Others may have played by the new rules but lost, either by managing their assets poorly or by seeing their carefully amassed savings wiped out in an Enron-type collapse. While each of these problems could have a different solution, various participants argued in favor of government payments for each group. Their focus was on Europe but their arguments could apply equally to the U.S.. They said that a system relying on individuals to manage the growth of much of their savings before and after retirement needs the government to provide a base level of payment for those who are unable to save, or who manage poorly, and have no assets when they retire. As government's role declined in the U.K., for example, the country acquired a serious level of pension poverty. The solution, in one view, is to introduce compulsory savings for retirement across the workforce, as Chile has done.

Diversification of savings portfolios

The more a pension system relies on funded pension schemes, and less on PAYG schemes, the more important it is for savers to be able to diversify their portfolios. Participants saw the need for greater diversity among instruments and across borders.

The relative weight of equity and bonds in retirement portfolios was an important topic of discussion among participants even though the issue has been debated for years. Some participants reminded their colleagues of a myth that economists disproved long ago: It is not true that equity held long term is less risky than debt. It is also debatable, they said, whether equity is an effective inflation hedge. Equity may give a higher return over many years than bonds but its risk is higher. Pension fund managers today do not understand or act on these principles, and they need to, according to these participants. But other participants disputed the idea that equity is no better than debt over the long run. This issue was not settled.

Participants raised two concerns when governments own equity in private companies. Corporate governance may be compromised even when the government invests only for long term growth, not control. Large pension funds, particularly in the U.S., have been shifting from a passive or neutral stance when they vote on company matters to using their holdings to shape management composition and decisions. An active government pension fund could wield great power. Participants also feared that a large government pension fund could be used to manipulate stock market prices, particularly for political ends. Some European countries already have a track record of government intervention in stock market prices. Participants did not want this type of intervention to persist.

The need to diversify fueled a discussion of the appropriate balance in occupational pension schemes between investment in the company's stock and in a diversified portfolio. The collapse of Enron, devastating the savings of workers who invested in its shares, was the graphic backdrop for this discussion. No one argued that firms should not be able to hold some of their pension funds in their own shares. Some participants argued for limits. They recognized that company pension funds run the risk of catering to the needs of the company rather than the investors. But companies downsize and become insolvent.

Diversification by country, participants said, is needed more than it is possible. The need arises in several ways. People do not want their retirement portfolios subject to the risk of a single country. The country's economy and stock market may be performing poorly when they retire, for example. They need to diversify to protect themselves. They also will want the best return, which may not be in their own country. But Europe has significant barriers to cross-border investment by pension funds, as described below in the section about Portability.

Participants disagreed about whether asset swaps may be a device that helps employers, individuals, and governments reduce or share risks when barriers prevent direct cross-border investment. For example, pension funds can use swaps to get the benefits of international risk sharing without creating large capital flows. Suppose a German pension fund wants some Indian risk. It can arrange a swap of a return on German equities for one on Indian equities. The cross-border flow is the net swap payment, not the full value of the underlying assets. Participants disagreed about the breadth of applications of this device. Skeptics said swaps would have only a limited usefulness. Much of a fund's obligations are in the fund's home currency, limiting demand for foreign currency denominated risk, for example. Others saw it as a "fabulous technical trick" that was useful for the international dimension of investment, extending beyond Europe and the U.S.

The relative openness and attractiveness of Europe compared to America as targets of investment did not arise as a significant topic among participants.

Portability

Europe has yet to make governmental or employer pensions portable among countries. Even portability from one employer to another in the same country is often constrained. Participants described this as a serious flaw. No one argued against portability. They emphasized the difficulties now.

Lack of portability among countries is a major drag on the integration of Europe's economy. Europeans need to be able to move their jobs from one country to another. They cannot do so easily now, partly because pensions are not portable. Companies operating across the EU must tailor their pension plans now to their employees in each country rather than provide a single system for all employees.

The EU draft Directive gives a passport for portability of occupational pensions but participants differed about its effectiveness. In the current draft, member states give mutual recognition to the pension rules and supervision of other member states that meet qualitative principles set by the draft Directive. An example of the problem is the employee of a company who is a citizen of and works in the company's EU home country. The company moves the employee to its office in another EU country. This host country commonly requires the pension for work earned in it to accumulate according to its laws and supervision. The employee might prefer to continue with the pension arrangements in the home country subject to its supervision, but cannot. It is not clear that the current draft requires this. Its qualitative principles concern basics for security, quality, liquidity, return, and diversification, that a host country might find lacking in the home country. Also, the draft governs listed types of institutions that provide occupational retirement, but excludes any that are PAYG as well as near substitutes like life insurance companies. The plan is to have the final directive in place by 2005.

Participants differed about a key part of the draft proposals for prudential rules, the "prudent person plus" standard for the employing firm. While most EU countries apply the prudent person standard to investment policy, some EU countries eschew it for quantitative prudential standards. The proposed rule in the EU draft Directive consists of a flexible prudent person standard plus a requirement that a firm take into account actuarial projections of its pension liability. Some participants found prudential plus a step forward, others saw it as retrogressive.

Tax reform in the EU will play an important role in the portability of pensions there, said participants. Harmonization of tax rules is not in the EU draft Directive, but tax needs to be addressed to achieve mobility. Even changes to specific tax barriers are a long way off. The process requires consensus. Some tax laws, including one just passed by Germany, make it hard for a person to move his or her pension from one country to another as the job moves. Tax is levied at different rates in EU countries. Tax is levied at different times: some countries tax when the savings are put into the retirement fund, while other countries tax when the income accrues or the principle grows, and still others when the benefits are drawn.

II. International Disclosure Standards

The discussion of international disclosure standards wove together three threads: a long-standing sense of unfulfilled need, a heightened urgency from the collapse of Enron, and a recognition of the hurdles facing efforts to design and implement common standards.

International disclosure standards prove elusive because the diverse national standards reflect profound policy differences. IOSCO tried, as one speaker observed, to harmonize disclosure rules for international securities transactions but succeeded only in general terms for information about such matters as business overview and risk factors. IOSCO's members could not agree about many difficult areas such as materiality, projections and forward looking information, indemnification of directors and officers, and the market risk of derivatives, so IOSCO simply reported different approaches that countries take.

Even when limited to disclosure in financial statements, common standards have been hard to put in place. The accounting standards of the International Accounting Standards Committee (IASC) for companies listing in global markets have been endorsed by both IOSCO and the BIS, accepted by most European exchanges, and by the European Union as of 2005, but the U.S. SEC has reserved judgment about whether the IAS standards could serve in lieu of U.S. GAAP.

The approaches that the U.S. and countries in Europe take to disclosure in their national markets differ in four important ways. These include the significance of disclosure, the regulatory and technical infrastructure supporting disclosure, and the role of shareholders.

Disclosure plays a much more significant role in the U.S. than many European countries. The U.S. relies on disclosure as a cornerstone of securities market regulation. Disclosure is not even a word in the language of many European countries language, said one speaker. Only 20 years ago, most European regimes had minimal standards, enforcement, and implementation. Today, their regulation of price sensitive information differs widely in law and practice. In 2001, for example, there were 175,000 announcements of price sensitive information in the U.K. and only 7,000 in Germany. The EU needs a common language of disclosure but has yet to tackle the diversity, said participants.

Compared to the centralized authority of the U.S. SEC, Europe still lacks the regulatory structure to enforce disclosure standards effectively. In Europe many statutory authorities and self-regulatory organizations (SROs) play an enforcement role. With "different interests, standards, and powers," in the words of one participant, they have little or no coordination. The decentralization of this dispersed authority makes it hard for European regulators to hold to high standards of disclosure.

Europe, unlike the U.S., lacks an infrastructure to integrate disclosure continuously, efficiently, and in a comparable way. Europe has fifteen different national systems. The U.S. has EDGAR, the automated Electronic Data Gathering, Analysis, and Retrieval system. It collects, validates, indexes, accepts, and forwards registration statements and periodic reports by all public companies (except foreign or small companies). Now almost 10 years old, EDGAR is accessible to anyone through the web, free. Europe, said participants, needs a counterpart.

Europe also lacks any important organization or agency to represent shareholders. This means that no spokesman spotlights the costs to investors that arise from inadequate disclosure, said participants. No one argues, on behalf of investors, for better disclosure rules before European securities regulators and law makers.

The variable and minimal regulatory infrastructure creates serious problems for Europe's securities markets, given the goals of consolidation and integration embedded in the Economic and Monetary Union, according to one speaker. For regulators and investors, cross-country comparisons are awkward within Europe, a problem that national tax law and accounting practice exacerbate. When potential investors hang back as a result, Europe's markets consolidate and integrate slowly.

All of these factors show that the U.S. and Europe come to international disclosure standards from different bases. Against this backdrop, participants at the Symposium discussed three major themes: basic concerns about disclosure, selective disclosure, and possible reforms.

Basic Concerns with Disclosure

Participants discussed the relative effectiveness of the market and regulators in setting standards for disclosure, the impact of continuous disclosure on managers and the danger of regulatory over-reaction to Enron.

More Efficient European Regulation

So far, EU initiatives to harmonize securities regulations have fallen short of their goal because, in a sense, the market trumped the regulators. For example, the past policy of mutual recognition has not succeeded, said participants.

Now, however, the EU is building toward a more coordinated regulatory structure that may increase the relative power of European securities regulators. With a goal of having an integrated EU securities market by 2003, the Commission decided in July 2001 to create two committees. They will work with the Commission to implement the Financial Services Action Plan. A European Securities Committee (ESC) of senior representatives from EU Member

States will advise on policy evolve into a regulatory group. An independent Committee of European Securities Regulators (CESR), an advisory body with representatives from Member States' governmental securities authorities, will advise on technical aspects of legislation and its implementation. The European Parliament accepted these nascent regulatory bodies, just before the Symposium.

Disclosure for sophisticated or retail investors?

Participants asked whether disclosure rules are mainly for sophisticated or retail investors. Sophisticated investors can evaluate issuers' disclosure regardless of the international standard used (US GAAP or IAS) but prefer not to have to use differing local standards. Retail investors, however, prefer disclosure in the local form that they use and know. For example, non-performing loans must be reported whether the standard is international or local. But the definition of NPL and the nature of the disclosure varies within Europe and between Europe and the U.S. An investor must be sophisticated to recognize the differences, which can be substantial.

In Europe, the layer of sophisticated investors is shallower than in the U.S. As a result, said one participant, much of the EU market is closed to the large group of middle level issuers from the U.S.– those below the top 1000, by one estimate. Retail investors in Europe do not know the U.S. GAAP rules these U.S. issuers follow and are reluctant to invest in them.

Fair value accounting

Participants debated whether Europe and the U.S. should move to fair value accounting. This issue arose in the keynote address by Andrew Crockett, General Manager, Bank for International Settlements. He noted that bank regulators are often leery of fair value accounting.

They find that it "risks imparting excessive short-term volatility and procyclicality to measured profits." He noted that securities regulators and accountants were much more open to fair value accounting. In his view, "The tension in perspectives will have to be addressed and overcome. I believe it can be."

A contrary voice strongly opposed fair market accounting for banks. It simply does not work for the many assets of a bank that have no public market value. Even if a market value could be determined, it could be misleading. It will not necessarily capture the range of values a portfolio may have under future alternative scenarios or the effect of existing provisions. The qualitative regulatory analysis remains essential.

Risk disclosure

Andrew Crockett also spoke in favor of efforts by regulators to strengthen disclosure of risks. He singled out market risk, particularly for derivatives, and noted that the New Basel Capital Accord looked to Pillar Three, or market discipline, which requires full risk disclosure. Crockett pointed out the tension between the needs for standardized information across institutions and for information tailored to the individual firm. Observing that "so far, the balance has been tipped strongly in favour of firm-specific solutions," he suggested exploring for standardized approaches in order to achieve greater comparability. Perhaps this would become possible as the state of our knowledge improves.

Another keynote speaker, Susan Bies, a member of the U.S. Federal Reserve Board, suggested that much needs to be done before detailed common standards for risk disclosure can be useful. Many tools to analyze risk – such as scoring models – have not been tested yet through a full credit cycle, and need validation.

Short-term management perspective with more continuous disclosure?

Continuous disclosure seems to be on the horizon in Europe, according to participants. European markets are now pressing issuers to make on-going reports instead of just relying on annual or semi-annual reports. Participants wondered about the implications of continuous disclosure for boards, the CEOs and management teams, and auditors.

Over-reaction to Enron?

"Several spectacular 'accidents,'" in the phrase of one speaker, highlight the significance of disclosure and may force governments to adopt bad policy. The Enron fiasco in the U.S. and Baan, Lernout & Hauspie in Europe prompted a public outcry in both continents for fuller disclosure about current and prospective conditions. The danger is that more complete and fuller disclosure standards set by regulators can have perverse effects. This speaker stated the FD paradox. When the SEC's Fair Disclosure rules called for companies to release forward-looking statements to the public rather than just to analysts, companies responded by cutting back on the information they released. In addition, there was concern that reaction to Enron could trigger rules that increase the role of the State and reduce the role of markets in setting and enforcing disclosure standards.

Critical participants asked how fraud on the Enron scale could escape for so long a regulatory system replete with all the U.S. bells and whistles. Enron eluded the SEC as well as the New York Stock Exchange. If the SEC's and NYSE's rules are not being followed, one must ask why? Perhaps the very complexity of the U.S. rules, said a participant, let the perpetrators escape detection longer than one would have expected. The SEC may be unable to streamline its rules, in response, because it reports to ten different Congressional committees, noted another.

These multiple overseers may partially offset the integrating impulse brought by having a single regulator in the U.S..

European participants, observing Enron, asked why Europe should try to emulate the US standards. They noted that at least three devices to protect shareholders had failed. The partial separation of accountants and consultants was one. Corporate governance rules against corporate transactions with related parties failed to prevent them. Analysts of issuers of derivatives in the energy sector failed to detect problems.

Timing of Disclosure

Europe and the U.S. differ in emphasis about the timing of disclosure, whether it should take place at regular intervals or promptly after the event. The EC proposed quarterly reports in its July 2001 consultation paper about on-going reporting obligations for all listed companies, and encountered significant opposition. European regulators tend to require disclosure at regular intervals but the practice is not uniform. In contrast, the US has long put greater store in prompt disclosure outside regular reports. Harvey Pitt, the SEC chairman, recently called for even prompter disclosure of new material information. Indeed, the EU consultation paper also called for prompt disclosure of any new information needed to make an "informed assessment" of the security if the information could move prices substantially. But, as one speaker noted, the effect of more continuous disclosure is to increase the cost to issuers. Is this cost worth the more rapid disclosure? More specifically, might it take time to determine if certain information is in fact material?

Selective Disclosure

Participants discussed a number of issues about Regulation FD, the U.S. requirement requiring that all disclosures of material information be made public to everyone, not just a selective few.

Preferential Treatment of Foreign Issuers

U.S. rules exempt foreign issuers from Regulation FD. Also, the 1,400 foreign or cross-border listings must use U.S. GAAP or reconcile to it, but they can file their annual reports as much as 6 months later. A participant asked why European companies could not complete their reconciliation in less than six months, noting that the sooner they complete it the sooner it would have an impact on the market.

Selective disclosure

In Europe, many believe in selective disclosure. In fact, a participant noted, Italy recently adopted rules permitting selective disclosure to encourage meetings with analysts. Participants pointed out that even the U.S. permits selective disclosure in certain circumstances. The rules exempt foreign issuers from Regulation FD, for example. Even though the governing U.S. rule is that selective disclosure harms retail investors, few if any participants spoke against selective disclosure.

If Europe adopted Regulation FD, would the role of analysts change, asked a participant. Would analysts in Europe be seen as less significant? If so, this might hurt the countries where analysts have not yet reached their potential market roles.

Should certain entities receive disclosure before investors?

Participants debated whether certain groups should be allowed to receive information before investors generally. Even the U.S. makes special provision for rating agencies. Regulation FD exempts disclosure to rating agencies from its general prohibition of selective disclosure. Their special function in the market is used to justify this policy.

That companies in EU countries have a statutory obligation to disclose information to employees in workers' councils surprised many U.S. participants. So did the discovery that this obligation might conflict with a listed company's disclosure obligations to its shareholders. How the conflict is resolved could have serious repercussions for either financial markets or social welfare. EU social directives now mandate that companies inform employees of certain matters before informing even their shareholders. This would undercut the uniform distribution of information to the market.

Should securities law also permit selective disclosure to others? For example, when public confidence may be at risk, should an issuer be allowed to selectively disclose information to regulators of, financial firms or health providers? Participants raised the questions but did not venture answers.

Possible Reforms

European countries today still must cover a great distance to implement the IAS rules by 2005, said participants, but even when they do greater reform is needed. Participants agreed that we lack a world-wide approach to the content of prospectuses and to disclosure generally. Perhaps, said one speaker, the growing use of offshore securities markets might help integrate disclosure standards worldwide. For example, advertisements of new offshore issues might contain identical information wherever made. Unfortunately, Europe seems to be proposing standards that would restrict offshore advertising. Such a rule would inhibit the integrating effect of the offshore market.

Adopt IAS rules

The difference in accounting standards between the U.S. and Europe is often characterized as a tug between rule-based standards, U.S. GAAP, and principle-based standards, IAS. Some participants saw the U.S. rules as respecting substance over form and, compared to IAS, bringing more detail while also allowing more choice. Comparing the two, the SEC itself found 255 variations, many significant, between U.S. GAAP and IAS. It has feared that countries will implement the IAS differently. These differences may be overstated, in the view of other participants. For example, the rule- versus principle-based distinction may be a false dichotomy, said a speaker. The standards of the IAS have been moving toward those of U.S. GAAP. In both, said a participant, the basic question is or should be whether you convey the economic truth in what you disclose. In one view, the only significant difference now may be enforcement. But if differences persist, a question is whether it is better to implement common accounting standards in different ways or to maintain several national standards.

The whole IAS/GAAP debate about approaches to accounting standards is increasingly out of date, in another view. The idea that there is a correct form of presentation is misplaced. There are easily three or four different ways to structure data, in this view, and no one way is more correct than another. Picking up on this point, another participant noted that analysts increasingly use cash flow to evaluate companies, rather than earnings. The market is moving in a direction that the SEC and European regulators are not yet ready to travel.

Will the US accept the IAS? In his published keynote speech, Andrew Crockett was optimistic. There is a political danger, however. The U.S. Congress, reacting to Enron, may cut back the role of the SEC on accounting matters. [This may happen to some extent with the passage of the Sarbanes-Oxley Act after the Symposium.] There are also conceptual problems. The meaning of "acceptance" by the U.S. is not obvious. The phrase may refer only to permitting foreign issues that comply with the IAS to trade in the U.S.. A broader interpretation would be that any issuer in the U.S. could use the IAS in lieu of U.S. GAAP.

The ability of European investors to work with U.S. GAAP or IAS depends on the investor. The big institutional investors are well accustomed to both. They drive market activity in Europe much more than their counterparts do in the U.S., where retail investors are a relatively more powerful force. The annual report is not of interest to institutional investors, prompting one participant to ask if a report for the fourth quarter was more appropriate because it could be assembled faster than the annual report.

Mutual recognition in Europe

Mutual recognition within Europe, as put in place by the EU, has not worked well. The Lamfalussy report said mutual recognition had failed for wholesale and retail markets, and fore exchanges. No participant contradicted this critique. In part, the problem lay in regulatory diversity and language differences, said one speaker. Insistence on the home language for prospectuses limited their access to investors across the EU. A broader view challenged even the premise of mutual recognition. Perhaps public offers do not need to be distributed in several countries. If investors can purchase the security somewhere in the EU, perhaps all that is needed is for member countries to continue not to apply their rules extraterritorially.

Still subject to national regulation, noted one speaker, are distribution and liability rules. Liability is a particular problem. The place of the offer determines which law governs. Some EU Members have specific rules while others leave it to general tort or contract rules. A pan-European offer could be governed by the laws of multiple countries. This would be costly for issuers and investors.

Integrate Europe's legal and financial infrastructure?

The barriers to integrating disclosure regimes within Europe extend deeper than the securities laws, said some participants. They include different clearance and settlement systems, and different legal systems, both of which provide the infrastructure for the securities markets and rules. Although the trading systems do not present a serious barrier, clearing and settlement are very segmented from country to country, according to one participant. Another argued that despite the integrating effects of the euro, the national civil codes, particularly as they affect ownership and insolvency, are different enough to prevent scale economies that would let European markets integrate. Europe needs a Uniform Commercial Code, particularly one that would impose the same rules about secured transactions across the countries. Until these differences erode or disappear, in this view, the regulatory segmentation will persist and disclosure rules are unlikely to become more unified and integrated.

Regulate accountants' conflict of interests?

Participants differed about the extent to which Enron called for a broad official response. In one view, fraud is a vice that sometimes escapes even the best constructed rules designed to prevent it. People need to understand that accounting and regulation have limited effects. They cannot prevent all bad deeds. A discovery that accountants, senior managers, or investment bankers committed fraud does not necessarily require new laws.

The danger of over-reaction to Enron, mentioned earlier, extends to Europe, said one participant. In Italy, for example, self-regulation is new. The government regulates accountants, who do not self-regulate yet, and Enron may discourage moves toward self-regulation.

Regulation must improve, said other participants. U.S. rules before Enron collapsed gave accountants and companies wide latitude. The big fees companies pay their auditors are a source of real pressure. One can protect against this. For example, said one participant, in the mutual fund industry the standards for fund self-regulation, SEC regulation, and regulatory audits really do keep the accountants and funds separate. In the U.K., noted another, the Myners Report said institutional investors should meet regularly with the audit committees of major companies. But in the U.S., instead of reporting to shareholders the audit committee is much too close to company managers.

III. Fighting Economic Crimes Against the International Financial System

Among the panoply of economic crimes, the topic of discussion was how the international financial system can play a useful role in the fight against international terror. Under this topical umbrella, participants discussed the new nature of terrorism, the breadth of the response, and the special problems of insurance and reinsurance.

Financing terrorism

Terrorists use the international financial system to hold and move funds that will finance the preparations for and carrying out of their criminal activities. The problem for a coordinated response to this new misuse of international finance is that the system already in place to counter criminal misuse of the international financial system was designed for a different purpose. More than a decade before September 11, 2001, governments had set up the Financial Action Task Force on Money Laundering (FATF), housed in the OECD. The goal of FATF was to oppose the use of the international financial system to disguise the origin of funds raised through criminal activities. The criminal acts, largely sales of illegal drugs, had already occurred before the funds entered the financial system.

On the existing FATF base, speakers said, governments started after September 11 to identify terrorists who use the international financial system to fund their activities. On October 31, 2001, FATF issued *Special Recommendations on Terrorist Financing*. These called on countries to make the financing of terrorism criminal. They should freeze and confiscate terrorists' assets. Financial institutions should report suspicious transactions related to terrorism. Countries should cooperate in this fight across the board – in criminal, civil, and administrative proceedings.

The U.S. Office of Foreign Asset Control is a leading actor. Its goal is to reduce significantly terrorists' use of the international financial system. To achieve this, it works with other governments and multilateral entities to dismantle the Bin Laden financial activities as a deterrent to other terrorists.

In the presentations and discussion at the Symposium, it became clear that participants believed the leading financial institutions were using their best efforts to help find and stop financing for terrorists. September 11 changed the cooperation between governments and their financial institutions from wary to active. The discussion also gradually revealed that there was little the private firms could do alone. The nature of financing terrorism differed significantly from money laundering in ways that made it very unlikely the existing international framework would usefully adapt to the new threat or that the financial firms would identify terrorist financing on their own.

Nature of the problem: not like money laundering

Terrorist financing is not like money laundering. A bank, said participants, will suspect money laundering if the amounts are large or fund unusual payments. A transfer will alert the bank if it comes from criminals or obscure sources, or through a tax haven or a company based in one of the identified countries that is not cooperating with the FATF initiatives. Certain types of businesses raise suspicions, such as casinos, cambios, internet gambling, or dealers in cars or boats. A transfer from certain types of non-bank financial institutions may catch the bank's attention. These red flags are largely missing, however, from terrorist finance.

Smaller amounts

Terrorists need and use relatively small amounts of money. The 19 highjackers on September 11 had accounts totaling $300,000, which at about $16,000 a person is such a small and frequent account size that it escapes detection as "unusual." They withdrew cash to pay for lodging, travel, food, and training, all very common uses of funds. Perhaps the characteristics of account holders should raise red flags, but too little is known now about the sources of terrorist funds to guide banks about what to look for.

This has two consequences. One is that a theoretical profile of a terrorist now is so general it describes far too large a universe of people to help banks identify prospective terrorists. The second consequence is that the smaller amounts let terrorists bypass the formal financial institutions and use instead informal money networks like *hawala,* outside the jurisdiction of regulators.

Not "laundering": not cash from crime

A second significant contrast with money laundering is that terrorist funds often come from a legitimate source. For example, terrorists might use several steps to disguise that the funds came from a legitimate investment account a Mr. ABC holds with a well known broker in an international financial center.

Different sources: religion, state

Sources of funds for terrorism vary, which is another reason profiling is so difficult. Some are deep pocket donors, rich individuals, or possibly even state agencies. A second source is religious; proceeds from tithing may be directed toward terrorism without the donors' knowledge. Participants from banks asked how they could know about the terrorist uses if the donors themselves were ignorant.

Government must identify the terrorists (banks cannot)

Participants concluded that banks must rely on the government to identify terrorists, by giving a name, multiple spellings of the name, or aliases. One participant described a bank's effort by itself to identify prospectively terrorist financing as "almost totally frustrating."

Breadth of action

How broad should the official and private action be to counter terrorist use of the international financial system? Client privacy has been a big political barrier to anti-terrorist and money laundering initiatives in the past. Today, however, privacy is not a big issue, said participants. Banks recognize the need to protect the information they have about customers.

But people now see the terrorist threat as great enough that they want to ensure that banks do not shield terrorists and become implicit collaborators with them. In one view, banks cannot protect criminals and, as terrorism is a crime, banks have a legal obligation to report about the accounts of people the banks are told, officially, are terrorists. It is not up to the banks to determine if a person belongs on an official list.

Participants discussed what should be reported, by whom, and whether the initiatives under way were likely to be effective.

What needs to be reported?

The money laundering rules encompass suspicious activities from drugs and the Mafia, and now the FATF has expanded this to terrorism. But is this enough?

A negative answer is given by the U.K. "all crimes" law, which now applies to any crime. This creates problems for the bankers. How does the bank determine if a crime has been committed? One participant described a simple rule of thumb his bank uses: is the source of funds a drug baron, corrupt head of state or a just a neighbor who did not pay all his taxes? It was not clear this would satisfy the new law.

Who has to report?

While no one disagreed with the position that banks should report suspicious activity and information about accounts owned by officially identified terrorists, participants did not agree how far the obligation to report should go beyond a country's own banks. Should the obligation extend to correspondent banks? In one view, correspondent banking may have to change. One participant noted that it may become necessary for correspondents of New York banks, for example, to submit to New York jurisdiction so they will respond to subpoenas for information about their accounts at the discretion of U.S. or state officials.

Beyond banks, participants asked, should the reporting rules extend to others? Perhaps lawyers or accountants should be required to report clients they suspect of terrorist activities.

The FATF *Special Recommendations on Terrorist Financing* in October 2001 called for special attention to the activities of non-profit organizations. They may be terrorist organizations in disguise, or they may be witting or unwitting conduits for terrorist funds, or they may hide the secret misuse by terrorist organizations of funds raised for legal uses.

Should the rules extend to the general public? The possibility of national identify cards was raised, participants noting that they were common enough in some European countries but an anathema in the U.S. Others pointed out that only four European countries made national identity cards compulsory and that the police did not find the cards useful if they were not compulsory. This suggested identity cards were unlikely to become a widespread response to the threat.

Will the fight against financing terrorism work?

A prerequisite for success is the ability of governments to work well together. It was the view of some participants that the U.S. and EU governments cooperated well, as did the multilateral institutions. Others, however, noted problems. Some said many countries still required a statutory basis for their government to cooperate with other governments. Another issue for participants was the impact of multiple official actors on financial institutions. The firms receive lists of names to check from different official sources. The lists overlap and the quality varies. The financial firms need a single list.

How much should EU cooperation with the U.S. on terrorism lead to U.S. concessions on other matters of concern to the EU? In one view, the U.S. was not acting consistently. It demanded absolute international cooperation with its initiatives to fight terrorism, but was unwilling to cooperate with the EU in matters of, for example, disclosure. This behavior could lead to adverse political consequences down the road. This view galvanized a response, expressed strongly by several participants, that the war on terrorism was radically different from policy differences on disclosure. People on both sides of the Atlantic fight terrorism now in order to prevent a similar tragedy in the future. All are vulnerable.

Terrorism reinsurance

After September 11, major reinsurance companies said that they could not afford to reinsure terrorist acts in the future without some official limit or protection. Insurers, reportedly, decided not to cover terrorist acts in the future. Without insurance, the construction industry slowed even more. The U.S. Government, having bailed out U.S. airlines, seemed ready to legislate protection for the reinsurers.

Why did the U.S. Government not follow through with legislation? Participants and speakers gave several reasons. As time passed without a second attack, it was hard to see why legislation was needed. The U.S. economy seemed to be recovering and most Congressional districts were not hit by the events of 9/11, so political support eroded.

The question for Congress was how to help insurers. Republicans and Democrats proposed very different solutions. Congress considered an approach based on the U.K., which was to set up agency to pool risk. Opposition grew as people concluded that an agency would shift responsibility to the government and make it harder for the private market to return.

Congress and the U.S. Government did not want more bureaucracy and particularly not another agency.

The issue became increasingly partisan. Democrats wanted to permit tort suits for punitive damages against U.S. businesses hit by terrorist attacks, delighting trial lawyers and infuriating Republicans, who used this debate to press for tort reform. Further, republicans wanted the government to be repaid for any help it gave. No bill has yet been passed.

In one view, this impotence reflected the lack of a Federal insurance regulator in the U.S. The President and Congress are both ignorant about insurance. Their difficulty assessing expert views was made worse by the lack of objective witnesses. One lesson was to educate policy makers and the political elite well before the next crisis.

Should we have it? In what form, how much, how long?

An argument against official support was that by withholding it, and thus reducing the insurance cover, the government would encourage people to take greater precautions and increase security. This view did not find support among participants.

Some participants supported the idea that government should help the reinsurance industry as it helped the airlines. Failure to help now would leave the industry and the world economy vulnerable to a second attack, for which the likelihood seems high. The next attack might create losses of about $50 billion. It is likely that insurance would cover as little as 10%. In that case, the U.S. government would be forced to step in directly, bearing a much greater cost to the public treasury than after the September 11 attack. An anticipatory government policy would help insurers provide a much greater proportion of cover through prefunding, at a much lower cost to the government.

Participants noted that support should be of limited duration. One did not want the government involved in this over the long term.

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