SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR EUROPE AND THE UNITED STATES

ELTVILLE, GERMANY • APRIL 22 – 24, 2005

FRIDAY, APRIL 22

18:00-19:00	Cocktail Reception - Lobby
19:00	Dinner – “Restaurant” **GREETINGS** Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies Hal Scott, Program on International Financial Systems, Harvard Law School Dr. Jürgen Stark, Vice President of the Deutsche Bundesbank Peter Tils, Managing Director, Deutsche Bank AG **KEYNOTE ADDRESS** Randal K. Quarles, Assistant Secretary for International Affairs, Treasury Department Gertrude Tumpel-Gugerell, Member of the Executive Board, European Central Bank
21:00-24:00	After-Dinner Cocktails – Room: “Weinstube”

SATURDAY, APRIL 23

7:00-8:30	Breakfast – “Restaurant” Breakfast Meeting of Panelists, Facilitators and Reporters Special tables are set up. Please sit at the reserved tables.
8:30-8:40	**WELCOME & OPENING REMARKS –** Room S2/S3 Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies Hal Scott, Program on International Financial Systems, Harvard Law School
8:40-9:00	**SESSION 1: BASEL II – THE IMPLEMENTATION OF BASEL II –** Room S2/S3 Europe Panelist: Bernhard Speyer, Head of Department, Deutsche Bank Research U.S. Panelist: Andrew Cross, Managing Director, Risk Management, CSFB
9:00-10:25	**SMALL GROUP SESSIONS**

Group Room	*Facilitators*	*Reporter*
1 Room S6	Chris Bates, Philippe Billot	Karel Lannoo
2 Room S1	Rainer Boden, Micah Green	Richard Herring
3 Room G1/G2	Guido Ferrarini, Robert Pickel	Hal Scott
4 Room G4	Thomas Leddy, Lutz Raettig	Brandon Becker
5 Room S4	Emilio De Lillo, Cliff Frazier	Eric Morgan de Rivery

10:25-10:40	Refreshment Break
10:40-11:00	**<u>SESSION 2: INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) – THE USE OF U.S. GAAP IN THE EU AND THE USE OF IFRS IN THE U.S.</u> –** Room S2/S3

Europe Panelist: Alexander Schaub, Director-General, Internal Market & Services DG, European Commission
U.S. Panelist: Friedhelm Kläs, Managing Partner, Deloitte

11:00-12:30 **SMALL GROUP SESSIONS**

Group Room	*Facilitators*	*Reporter*
1 Room S6	Stefan Gavell, Ulf Grunnesjö	Hal Scott
2 Room S1	Koen Coppenholle, Dagmar Linder	Karel Lannoo
3 Room G1/G2	Emily Altman, Joseph Seidel	Richard Herring
4 Room G4	Lisa Rabbe, Cezary Stypulkowski	Brandon Becker
5 Room S4	Erich Harbrecht, Mark Sobel	Eric Morgan de Rivery

12:30-14:00 Lunch – “Restaurant”
<u>KEYNOTE ADDRESS</u>
Dr. Jürgen Stark, Vice President of the Deutsche Bundesbank

14:00-15:00 **<u>SESSION 3: MARKET STRUCTURE – TRANS-ATLANTIC TRADING OF SECURITIES</u>**
Plenary Discussion only – Room S2/S3

Europe Panelist: Paul Arlman, Secretary General, Federation of European Securities Exchanges
U.S. Panelists: Manfred Schepers, Executive Vice President and Senior Managing Director, The Bond Market Association

15:00-17:45 Free Time

15:00-17:30 Reporters Meeting (from Small Group Sessions) – Room G3

17:40-17:55 Group Buses depart to Kloster Eberbach

18:00-21:30 Cocktail Reception and Dinner at Kloster Eberbach - Mönchsrefektorium

<u>KEYNOTE ADDRESS</u>
Philippe Lagayette, General Manager & Chairman of the Management Committee, JPMorgan Paris
Suzanne Nora Johnson, Vice Chairman, Goldman Sachs

21:30-21:45 Group Buses return to the Deutsche Bundesbank Training Centre

21:45-24:00 After-Dinner Cocktails at the Training Centre – Room: “Weinstube”

SUNDAY, APRIL 24

7:00-8:30	Breakfast
7:00-8:30	Breakfast Meeting of Discussion Chairs and Reporters Special tables are set up. Please sit at the reserved tables.
8:30-9:25	**SESSION 1: BASEL II – THE IMPLEMENTATION OF BASEL II** Presentation & Discussion – Room S2/S3 Europe Chair: Andreas Ittner, Director Financial Institution and Markets, Österreichische Nationalbank, Member CEBS Bureau U.S. Chair: Charles Ilako, Lead Partner, Global Financial Services Regulatory Practice, PricewaterhouseCoopers, LLP
9:30-10:20	**SESSION 2: INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) – THE USE OF U.S. GAAP IN THE EU AND THE USE OF IFRS IN THE U.S.** Presentation & Discussion – Room S2/S3 Europe Chair: Nicolas Véron, Development Manager, Bruegel & Founder, ECIF U.S. Chair: Francois Veverka, Executive Managing Director, Institutional Affairs, Standard & Poor's
10:20-10:30	Refreshment Break
10:30-11:20	**SESSION 3: MARKET STRUCTURE – TRANS-ATLANTIC TRADING OF SECURITIES** Presentation & Discussion – Room S2/S3 Europe Chair: Peter Scherer, Partner, Clifford Chance U.S. Chair: Emily Altman, Director, International Government Relations, Morgan Stanley
11:20-13:30	Closing Lunch – "Restaurant"

SYMPOSIUM REPORT

BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY:

AN AGENDA FOR EUROPE AND THE UNITED STATES

April 22-24, 2005
Eltville, Germany

BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR EUROPE & THE UNITED STATES
ELTVILLE, GERMANY APRIL 22-24, 2005

The Bundesbank training center, overlooking the Rhine River, proved a fitting location to discuss the implications of regulatory differences between Europe and the United States (US). That section of the Rhine is dotted with a picturesque series of towers, which are all that remain of a cumbersome network of tolls that local governments of an earlier era levied on river commerce. Each government was attempting to regulate commerce within its own borders, in its own interests but with little regard for the cross-border impact of its actions. The consequence was a heavy drag on river commerce that undoubtedly reduced rates of economic growth and lowered standards of living. This tension between the needs of national regulators and supervisors and the needs of cross-border business was echoed throughout this meeting.

This symposium focused on three sources of regulatory differences between the European Union (EU) and the United States: (1) differences in the implementation of Basel II regulations; (2) divergences between International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Standards (GAAP); and (3) differences in the regulation of market structure. In each case some participants expressed a concern that the divergent trends between Europe and the United States could undermine prospects for trans-Atlantic financial integration.

Session 1
The Implementation of Basel II

HOME/HOST ISSUES

Although Basel II regulations will be introduced by 2007 in the EU and by 2008 in the United States, many of the details of implementation are still not clear. What is clear, however, is that the EU and the US are taking different approaches to the implementation of Basel II and that these differences may prove costly to banks that are active in both markets. Some of these problems are the consequence of sharing supervisory and regulatory responsibilities. While these tensions between the home and host country are present under the Basel I regime, they are likely to be greatly exacerbated by several features of Basel II.

First, multinational banks are likely to be subject to different capital standards in different countries. Basel II affords several different choices for computing capital charges under Pillar 1. For example, a bank may be required to use the Advanced Internal Ratings (AIRB) approach for computing capital charges on its corporate lending in one country, but the Internal Ratings (IRB) approach in another, and the Standardized approach in yet another. Thus the same quality corporate credit could get a different capital charge in each of the three countries. Moreover, these choices may be different for different lines of business. Thus a large multinational bank active in scores of countries may be obliged to employ a complex array of approaches in computing its regulatory capital charges.

Second, even when countries choose to implement the same Basel II options, the rules may be implemented quite differently across countries. The EU provides a striking example of this problem. The EU has provided supervisors with 143 different options for implementing the rules. Thus, even within the EU, an internationally active bank may face considerable regulatory and supervisory complexity arising from differences in implementation alone. This complexity is not without significant cost.

Multinational banks tend to manage risks on a consolidated basis, without regard to the corporate structure (whether branch or subsidiary) of the offices through which business is conducted. They would, of course, prefer to have one set of rules in which the home country supervisor sets the standards it must meet worldwide. But this approach is unlikely to be feasible. (See discussion of potential solutions below.)

The US has dealt with this problem by requiring any foreign-owned bank to form a US subsidiary if it wishes to issue insured deposits and therefore be subject to the same regulation and supervision as domestically-owned banks. This option is not available to EU member states, however, because the EU has adopted the principle of a single EU passport. This means that a bank that obtains a charter in any member state may form branches in any other member state without additional regulatory permissions. Thus, the host country can not require that a foreign bank headquartered in another EU member state form a subsidiary instead.

So far, there has been surprisingly little cross-border retail banking in Europe and most of it has occurred as a result of cross-border acquisitions in which the identity and charter of the acquired bank are retained. Nonetheless, this pattern may change. Nordea Banken has announced its intention to restructure its Scandinavian network as an EU-charted corporation, headquartered in Sweden with branches in Denmark, Finland, Norway and Sweden. Since the existing subsidiaries are systemically important in each of these countries, host country supervisors are unlikely to be willing to simply defer to the Swedish supervisor. Although it is possible that cooperation among Scandinavian supervisors is sufficiently strong to improvise a workable solution, it's easy to imagine instances in which cooperation would be unlikely. Is the Nordea Banken action unique? Or is it a harbinger of restructurings to come?

VARIATION IN SUPERVISORY COMPETENCE AND DATA ACROSS COUNTRIES

Some participants expressed concerns about variations in supervisory competence across countries. This took two forms. First, Basel II makes much heavier demands on bank supervisors than Basel I. Bank supervisors must hire and retain staff who are competent to understand and evaluate the complex models that underlie the complicated computations necessary to implement the internal ratings based approaches and the advanced approaches to computing capital charges for operational risk. They will be competing in the market place with the institutions they oversee for such talent. Traditional, civil service levels of compensation are unlikely to prove adequate. It is an open question whether some host countries can hope to acquire and retain the expertise to fulfill their responsibilities.

Second, Pillar 2 of the Basel II Agreement implies that supervisors may become virtual partners in the internal capital allocation process of the banks that they supervise. The Internal Capital Adequacy Assessment Process (ICAAP) requires that supervisors review considerable proprietary information. Some private sector participants expressed concerns that some host countries would not adequately safeguard such information. This might lead institutions to attempt to conceal information that should be shared with supervisors and will thereby impede the development of institutional competence. Regulators and supervisors, in contrast, insist that confidentiality is not an issue within the EU or US.

Participants were also concerned about the obstacles facing the most sophisticated international banks in applying capital models to their consolidated positions. The data requirements for applying the internal-ratings-based approaches, particularly the advanced approach, are formidable. While international banks have developed appropriate data sets in many advanced countries, the quality and quantity of available data is much weaker in most other countries. Unfortunately, data from advanced countries should not be used to calibrate models in other countries. Credit risk models should vary from country to country just as bankruptcy and foreclosure laws and the enforcement of those laws varies. In particular, the probability of default and the loss given default – two of the key parameters in the AIRB – should be expected to vary with these differences in the financial and legal infrastructure. Moreover, in countries that are rapidly transforming from a command and control system to a more market-based system, the relevance of historical data is highly doubtful.

POTENTIAL SOLUTIONS

What possible ways are there to mitigate these problems? Some participants expressed hope that the Accord Implementation Group (AIG) would be able to reduce some of the complexity, but others noted that the AIG has focused solely on information sharing, not simplification of the rules. The Committee of European Banking Supervisors (CEBS) is attempting to reduce some of the complexity within the EU and it has established direct contacts with the relevant US supervisory authorities. The agenda of CEBS includes the aim of achieving convergence in both the substance and process of supervision within the EU. Nonetheless, even the most optimistic forecast of what CEBS could achieve was a reduction in the 143 options for implementation of Basel II to a number still substantially more than 100.

Within the EU there appears to be some support for the concept of a “college of supervisors.” A supervisory college would be established for each multinational bank in which supervisors from the home country and the various host countries would share information and harmonize their requirements for the particular multinational bank. To some participants this sounded like the arrangement improvised for BCCI. Although it might well be expected to work better for a bank that was not a criminal enterprise, the precedent is hardly reassuring. Moreover, it has several inherent problems. First is the question of which supervisory institutions should be invited to participate. In many countries such as the United States, a number of supervisory agencies may have a legitimate interest in and statutory obligations with regard to a bank. But if all such institutions are invited this could lead to a very large and heterogeneous supervisory college. Deutsche Bank, for example, has operations in 73 different countries. But size and heterogeneity tend to exacerbate the defects that plague most committees – slow and cumbersome decision-making – and might prove unworkable in a crisis.

Some participants argued for a lead supervisor model in which the home country supervisor would establish the rules under which a multinational bank operated and host country supervisors would play a junior role. Others argued this model was not feasible unless the home country were willing to issue a guarantee for the external liabilities of the bank. In addition, one supervisor noted that it could result in multinational banks from different home countries playing under different rules in the same host country which was, in his view, an unacceptable breach of the level playing field standard.

Several participants expressed the hope that the EU would remove some of the complexity by developing an EU supervisor that would supercede the national supervisory entities in the twenty-five member states. But the EU currently faces real uncertainties about what entity would be the lender of last resort in the event of a cross-border banking crisis. In such circumstances, officials emphasized that national supervisory authorities cannot cede responsibility for safety and soundness to an external supervisory authority. They argued that until an EU budget is established to clean up problems that might result from a banking crisis, there could be no prospect of an EU supervisor that could supercede national supervisors.

COMPETITIVENESS ISSUES

The attempt of Basel II to achieve a level playing while at the same time providing capital charge incentives for banks to adopt more sophisticated risk management techniques is inherently contradictory. A number of participants raised questions about whether Basel II might tilt the playing field among banks and between banks and other financial institutions.

The US has interpreted the Basel II framework as *standards that should apply to internationally active banks*, while the EU has viewed Basel II as *internationally accepted* *standards that should apply to all banks*. In consequence, the US and the EU have taken divergent approaches to dealing with the level playing field issues raised by Basel II. The US has chosen a "bifurcated" approach. Ten large, internationally active US banks with more than $250 billion in total assets or with foreign exposures greater than $10 billion will be required to qualify for and implement the advanced approaches to calculating capital charges for credit risk and operational risk under Basel II. Another ten or so large regional banks are expected to "opt-in". All other banks will continue to apply the Basel I regulations, which may be amended.

In contrast, the EU has chosen to incorporate the Basel II framework in its capital requirements directive that will apply to all depository institutions and most types of investment firms. This choice has probably contributed to the complexity of the Basel II framework. The desire to be sensitive to the differences among the broadest range of financial institutions led to the inclusion of numerous options in the rules and implementation of the rules. In essence, the earlier Basel I objective of simplicity was traded off against breadth of scope. Moreover, the solution to almost every subsequent problem posed by industry groups is still more complexity in the rules or options for applying the rules.

Both the US and the EU are facing complaints from firms that fear they will be disadvantaged by Basel II. Since the advanced approaches, which will be required in the US, are calibrated to produce the lowest capital charge for most exposures, banks that believe they cannot qualify fear that they will be placed at a competitive disadvantage. The US regulatory authorities have addressed these concerns in two ways. First, they have produced several studies that tend to show that any competitive effects are likely to be minimal because banks that do not adopt Basel II will not be subject to a capital charge for operational risk (which will apply to those banks that do adopt Basel II) and because banks that do adopt Basel II will continue to be subject to a separate leverage capital requirement. Second, they have indicated a willingness to adjust Basel I to compensate for any remaining differences. It seems likely, for example, that the risk weight for residential mortgages will be reduced from 50 % to 35% and the risk weight for retail lending may also be reduced.

The EU has addressed similar concerns by permitting institutions based in the EU to make choices among the several options provided in the Basel II framework and has, in addition, provided 143 implementation options. Unlike US institutions, EU institutions will be able to choose different approaches for different categories of business. Thus EU supervisors must deal with the possibility that institutions will engage in a kind of “regulatory cherry-picking” in which institutions select the regulatory option that will give them the lowest capital charge for each line of business. The resulting complexity led one prominent EU official to question whether the EU should have sought to apply the framework to smaller institutions.

Concerns were also raised about whether the prospect of lower capital charges and national interests in securing a competitive advantage for domestic banks may result in institutions adopting the advanced approaches before they are fully ready to do so. For example, some participants doubted whether the 47 German banks that have applied for permission to use the AIRB – more than twice as many as in the United States -- were really fully prepared to do so. Others, however, emphasized that German banks have simply invested much more heavily in preparations for Basel II than banks in other countries.

Both the US and EU must deal with concerns that Basel II will alter the competitive structure of the financial system. One possibility is that lower capital charges may enable large, internationally active banks to acquire smaller banks simply because they can fund them more cheaply. This could lead to consolidation of the financial sector motivated by regulatory advantage rather than value added to consumers of financial services.

More broadly, both the US and the EU must also deal with concerns that the costs of complying with Basel II could lead to a shift of products and services from regulated institutions to institutions not subject to Basel II. Here too the difference in the scope of application has led to differing concerns in the US and the EU. The EU has chosen to apply Basel II on a consolidated basis not only to all depository institutions, but also to most investment firms. Thus when an EU-based investment firm competes in the US it will be subject to substantially different regulation than its US competitors. In the US, this concern has been expressed mainly with regard to banks that have specialized in asset management and processing businesses. For these banks the new regulatory capital charge for operational risk will not be fully offset by a decline in the capital charge for credit risk and so they are concerned that they may lose business to nonbanks, not subject to capital regulation.

Participants from both the EU and the US expressed concerns that capital charges against the trading book might cause proprietary trading and, perhaps, several other asset management functions to shift increasingly from regulated banks to unregulated hedge funds.

Some feared this was likely to reduce liquidity and undermine the stability of the financial system.

MARKET DISCIPLINE AND POLITICAL LEGITIMACY

Although Market Discipline is the third pillar of the Basel II framework, it received short shrift in our discussion of implementation issues (and arguably, in the Basel Committee's proposal as well). Some participants noted that Basel II was more about disclosure than market discipline and was notable for its failure to introduce principles of structured early intervention and prompt corrective action that could make market discipline meaningful. Some participants argued that the prescriptive nature of the Basel II framework would undermine market discipline by increasing the likelihood that the supervisory authorities would need to assume responsibility in the event of a banking crisis and provide a bailout. Several participants were concerned about the expanded role of rating agencies under Basel II. They asked whether the ratings agencies should not be subject to regulatory oversight as well.

Finally, the hope was expressed that the Basel Committee could be kept out of politics and would remain a group of technical experts focused exclusively on financial sector objectives. Others believed this to be naïve. They argued that the decisions made by the Basel Committee may have far-reaching implications about competition (both across borders and within countries) and macro-economic stability. In their view, politicians cannot be expected to permit these decisions to be taken solely on narrow, technical grounds. In this regard some mentioned the intervention of the German Chancellor in the Basel Committee decision regarding the reduction in capital charges for small and medium-sized enterprises. Others saw the fingerprints of the White House and Congress on the Basel Committee decision to reduce capital charges for retail lending, given that reserves are already required for expected losses.

More broadly, questions were raised about the political legitimacy of the Basel approach. The international capital standards formulated by the Basel Committee are inevitably applied to a very broad range of countries that have not had a direct voice in the process. More than 100 countries have adopted Basel I and early indications are that at least 50 to 75 countries will be adopting Basel II. The problem is not only one of form, but also one of substance. Capital standards formulated for the advanced economies represented in the Group of Ten may not be appropriate for countries with less developed financial and legal infrastructures. Indeed, premature adoption of Basel II standards could exacerbate financial instability in such countries. Unfortunately, no one suggested a solution to this problem.

Session 2
International Financial Reporting Standards
The Use of US GAAP in the EU and IFRS in the US

THE PROBLEM

For a number of years several member states of the EU have accepted US GAAP (Generally Accepted Accounting Principles) as equivalent to their own national accounting principles. In contrast, since 1982 the US has required that foreign firms that list their securities in the US must reconcile their accounting statements to US GAAP. As a result, a number of European firms that have chosen to list in the US have adopted US GAAP for all financial reporting. The conversion to US GAAP has been very costly, requiring expenditures in several cases of more than $100 million.

The EU has now chosen to adopt International Financial Reporting Standards (IFRS). Three directives – the conglomerates directive, the transparency directive and the prospectus directive – require that all firms listed in an EU member state must report using IFRS unless IFRS and US GAAP are deemed equivalent. The Committee of European Securities Regulators (CESR) was studying at the time of our meeting whether US accounting rules – and also those of Canada and Japan – should be deemed equivalent. Member states have the possibility of creating an exception for firms that wish to continue to employ US GAAP, but, in the absence of an equivalency finding, the exception must end by 2007. To date Germany and Belgium have created the exception.

When the International Accounting Standards Board (IASB) was formed it was envisioned that it would produce a common set of standards that would be employed by all developed economies. After several years, however, the standards are in Europe only. Australia, Canada and Hong Kong use versions of international accounting standards, but they are not identical and an EU corporation would face additional reporting requirements to list in those markets.

The principles-based IFRS differ in many details from the rules-based US GAAP. Although the IASB is working in the Convergence Project with the Financial Accounting Standards Board (FASB), which sets standards in the United States, to eliminate major differences, many important differences remain.

If US GAAAP should not be judged equivalent to IFRS by 2007, many internationally-active firms will be faced with the heavy costs of preparing their financial reports according to two different accounting standards or retreating from participation in both EU and US capital markets. European firms that have converted to US GAAP will be required to use IFRS as well. US firms that have been able to rely on US GAAP reporting in the EU would be required to make reports in IFRS as well. This is expensive and can lead to anomalous results, such as profits transformed into losses, that undermine the credibility of financial statements and transparency in the market place. This would constitute a serious setback in a long-term trend of increasing integration between US and European capital markets.

Up to the very day the symposium began, there appeared to be little hope of progress. But just as the meeting commenced a “roadmap” and a breakthrough in negotiations between regulatory officials in the EU and US were announced.

THE ROADMAP

The road map indicates a path by which European securities may be allowed to sell securities in the US without having to reconcile reports prepared according to IFRS to US GAAP. The road map aims to reach this objective by 2009 or, perhaps, as early as 2007, assuming that IFRS and US GAAP had sufficiently converged. However, since the press release produced by the EU commissioner for internal markets differed from that produced by the Securities and Exchange Commission (SEC) -- even with regard to whether the exchange that took place was an “agreement” and the road map turned out to be a law review article published by the SEC’s chief accountant, there was considerable discussion about whether this was actually a breakthrough.

The 2007 date, of course, corresponds to the time by which the EU must reach a decision regarding the “equivalency” of US GAAP to IFRS. The presumption is that if sufficient convergence has occurred for the SEC to proceed along the road map, the EU will find that US GAAP is equivalent.

While this appears to be progress in dealing with the impending problem, at least in political terms, participants raised questions about a number of issues. What is meant by convergence? Identical principles or rules? Some participants asserted that the road map indicated that the debate had moved beyond mutual recognition to focus on convergence.

Equivalence, it was noted, is a unilateral judgment that another set of rules is just as good as or better than local rules and is similarly implemented. But does this mean equivalent principles or rules? Comparable principles or rules? Or, merely, compatible standards (the new term introduced in one of the press releases)? What differences actually need to be eliminated? How much convergence is sufficient?

One participant asserted that convergence is a process--a process that will never be terminated until we have a single set of rules. But since the process is unlikely to end with one agreement, both standards will continue to evolve and, thus, there will be a continuing need for attention to convergence. The key is that the two sets of rules must be moving closer together. What will be the mechanism for assuring that standards that had converged sufficiently at one point to permit a judgment of equivalence do not subsequently diverge in unacceptable ways?

One EU official warned that equivalence requires a complex judgment. It is not just about the equivalence of rules; it is also about the equivalence of enforcement. Even if rules are nearly identical, if enforcement is very different, one cannot make a finding of equivalence.

A number of participants expressed concerns about the speed of convergence and the uncertainty about whether either of the target dates could be met. This uncertainty is likely to overhang the market for some time. Will convergence happen? When? Will it be 2007? 2009? Or never? Uncertainty about convergence can be very costly. If firms are not certain that equivalence will prevail in 2007, they may need to start allocating resources now to develop a dual reporting infrastructure. And EU firms that have not adopted US GAAP, will need to reconcile their accounts to US GAAP at least to 2007, if not 2009, and possibly for the indefinite future.

One participant warned that given the number of differences between the two standards, (more than 130) the roadmap must be considered to have a very aggressive timetable. It may be hard to meet either target. Indeed, the participant argued that the dates should be considered more as an aspiration than as a target.

ENFORCEMENT OF A DUAL ACCOUNTING STANDARD

Assuming that the road map leads to the adoption of a dual accounting standard, how will this work for implementation and enforcement? Will the SEC and the US courts be permitted to make an interpretation of international accounting standards? How would registration statements be treated in host countries? Will the SEC review statements approved by the home country authority? Will the SEC continue to review the adequacy of accounting practices? Would national EU regulators, such as the FSA in London, review the statements approved by the SEC?

Within the EU, officials face a major challenge in harmonizing enforcement because interpretation and enforcement of the IFRS in the EU remain national prerogatives. Moreover, the principles-based approach appears to leave huge scope for differences in implementation. A European participant asked whether the EU can have credible accounting standards in the absence of centralized enforcement powers to ensure consistency in the application of international accounting standards.

Some participants expressed concern that the road map would lead to a competitive disadvantage for US firms because it would provide EU based firms with an option—a choice of standards--not open to US firms. Under the roadmap, EU companies can choose either US GAAP or IFRS. But US firms must still use US GAAP.

ALTERNATIVES TO THE ROADMAP

Putting aside political constraints, participants were asked to identify alternatives to the roadmap. One participant suggested that rather than trying to achieve convergence between two flawed standards, it would be better to undertake a more fundamental reform and make a joint effort to develop better accounting standards. Another participant suggested mutual recognition now, without insisting on further convergence, but with enhanced disclosure of the differences.

But others objected that to settle for two standards was to accept defeat. Even if the SEC accepts IFRS, there will be no single standard. They urged that the standard setters to return to the vision that motivated the establishment of the IASB and try to develop a single, global standard. With two different standards you are likely to have two different interpretations of the value of the same economic enterprise. This cannot be helpful to investors, whose voices have been oddly silent in most of the debates over accounting standards.

There was not unanimous support for the concept of a single, global set of standards. The doubters expressed concerns that innovation could decline if there were a monopoly standard setter. They saw positive benefits in having two standard setting bodies that would develop competitive standards. Others viewed this concern as inconsequential, noting that the FASB has had a monopoly in the United States for decades and concerns have seldom been raised about its ability to deal with innovations.

LEGITIMACY OF STANDARD SETTING PROCEDURES

Policymakers on both sides of the Atlantic saw merit in insulating the standards setting process from politics. Both believe that standards should be treated as technical issues to be dealt with by technical experts. Nonetheless, political considerations do intrude. The US Congress has attempted to meddle in FASB's efforts to expense stock options. More recently, the European Commission intervened in the IASB attempt to set standards for the accounting of financial instruments. The Commission has demanded that the IASB revise its rules in a way that will satisfy Continental European banks and gave European companies permission to opt out of complying with major parts of International Accounting Standard (IAS) 39.

This friction over standards for the accounting for financial instruments led to troubling questions in Europe about the legitimacy of the standard setting process and the appropriate relationship of the standard settings body to the political authorities. EU officials began to ask why there were so many Americans and so few Europeans on the IASB, especially since the US has decided not to apply IFRS. After all, some argued, wouldn't the US be concerned if most of the members of the FASB were European? There was even some lose talk about creating geographic quotas for membership on the IASB.

During the dispute over IAS 39, the European Commission also began to raise perplexing issues of accountability and how the IASB is funded. In the US FASB is subject to oversight by the SEC and can be overruled by the SEC. But, the European Commission does not have comparable powers with regard to the IASB. The European commissioner for internal markets has stated that the EU wants accounting standards set independently, but that there should be some level of accountability as well as transparency with regard to how they are set. Precisely what this means has not yet been specified.

An EU official noted that governance issues will become easier to deal with if the road map succeeds.

Another participant warned that we should be under no illusion. Standard setting is not purely technical. It is economic policy. This will have an impact on economic behavior, especially in Continental Europe, where the investor-oriented perspective of the new rules is quite different than the traditional approach. Thus the IASB should apply the "Spiderman Principle"– with great powers, come great responsibilities. The IASB is only slowly recognizing this fact. It is very different than the FASB which is subject to the control of the SEC and Congress. IASB reports to "international investors". But how are they reporting and how are they held accountable?

Some participants suggested that a better way for the IASB to deal with political pressures might be to follow the US example and create specialized rules for industry segments, as for example, GAAP for insurance, movie-making, etc. The US also has used regulatory accounting rules to defuse controversy. When controversy arose over the volatility that would be introduced in bank capital with mark to market accounting, the US created special rules for computing regulatory capital, even though the general rule was mark to market. This special rule was later withdrawn, but it eased the transition.

In conclusion, one participant urged that officials not lose sight of the needs of international investors in responding to special interest groups. He posed the question, "What are investors telling us about the differences between IFRS and US GAAP currently?" He noted that a growing body of empirical studies indicate that when EU issuers first disclose according to IFRS and then reconcile to US GAAP, there is very little reaction in market prices, which implies that the costly process reveals very little additional information. From this perspective, we may have achieved closer convergence than the technical experts and politicians appear to have realized.

Session 3

Market Structure – Trans-Atlantic Trading of Securities

Recent Developments Regarding European Securities Exchanges

European exchanges have been remarkably successful in attracting remote membership. That has created a clear integration effect. But from the regulatory perspective the emerging landscape is very complex. Regulation remains a national prerogative and so it is important to take account of jurisdictional issues in Europe. But to some extent cooperation among various exchanges is compensating for lack of harmonization at the EU level. Both OMX and Euronext have developed their own private sector regulatory integration regime without any involvement by the EU.

All trading is electronic in Europe. Do exchanges compete? Yes, for new listed companies, although EU regulations still require that each company list in the member state in which it is chartered. Yes, for who trades particular stocks and also in vending exchange-related technology. Indeed, this openness to competition extends to takeovers by entities outside the EU. An American corporation acquired IPE in London in 2001. Some Europeans questioned whether the US would be as open to the acquisition of a US exchange by a European corporation. A US participant quickly replied that, despite intense opposition from local entrenched interests, Euronext had been permitted to establish an electronic futures trading system in Chicago. Although the venture didn't gain much market share it caused a transformation in the way in which local competitors operate. Permission for placing EU exchange trading screens in the US remains a contentious issue. Some believe that it would enhance competition and reduce brokerage commissions. But the SEC has been reluctant to address the issue, although one participant expressed the view that it may be willing to do so if the road map is successfully completed.

Cross-border clearing and settlement remains a problem in the EU. It is technically superb within borders. But cross-border, it is 5 to 10 times as expensive as domestic US transactions. Some participants argued that the additional costs were due to the costs of making cross-border payments rather than clearing and settlement per se. Others contended that the vertical integration of many exchanges, in which the exchange also owns the clearing and settlement mechanism, contributes to the costs and may raise anti-trust concerns.

DIFFERING APPROACHES TO MARKET STRUCTURE REGULATION

Recently both the US and EU have thought deeply about questions of market structure for equity trading but come up with different answers. (See the new SEC Regulation NMS and the EU market and financial instruments directive (MiFID).) The US has required price priority through a trade-through rule, regulated fees, and banned sub-penny pricing. All the EU has done is to require transparency. The following table summarizes the key points:

Contrasting Approaches to Market Structure Regulation

	US	**EU**
Pre-trade transparency	Yes	Yes
Pre-trade transparency including orders not exposed the market (internalized)	Yes	Yes
Post-trade transparency	Yes	Yes
Requirement that broker send order to market with best price (trade-through rule)	Yes	No
General best execution for brokers	Yes, but price priority	Yes
Data fee controls	Yes	No
Access fee limits	Yes	No

Will these differences inhibit the development of a trans-Atlantic capital market? Should regulators start thinking about a trans-Atlantic approach to market structure? The answer is necessarily speculative because neither the US nor the EU has fully implemented their new market structure regulations.

Some participants posed the more fundamental question, "What is a trans-Atlantic capital market?" Another participant responded that trans-Atlantic capital markets are widely heralded, but hard to specify. He noted that the major players in both EU and US capital markets tend to be the same institutions confronting the same kinds of developments with regard to technology, the significance of trading platforms vis-à-vis exchanges, pressures for consolidation and increasingly complex regulations. Moreover, the products tend to be quite similar, notwithstanding the American obsession with registered securities and the German obsession with bearer instruments. Most companies find that they are currently able to tap investors on both sides of the Atlantic. There is some cross-listing, but even more crossinvesting because trading inevitably migrates to the location with the greatest liquidity. How would a trans-Atlantic capital market differ?

A number of participants urged that official not attempt to harmonize market structure regulation. They argued that we are likely to achieve a better result if we proceed with competition between the two market structures and let issuers and investors choose.

FIXED INCOME MARKETS IN THE EU

Fixed income markets are the success story of the single market initiative in the EU. Both bond and derivatives markets have thrived. There are substantial increases in the issuance of bonds and even stronger growth in asset-backed securities. Now EU activity is similar in volume to the US, dominated largely by intra-European trades.

The introduction of the euro reduced currency risk and transactions costs. Pension funds and other institutional investors have taken up long-term debt. Moreover, the increasing emphasis on risk management has led to increased issuance of structured products. Investment patterns have also changed. Households have diversified away from government bonds and equity and into fixed-income instruments issued by the private sector. Demographic and fiscal pressures to increase private funding for European pensions are likely to lead to an increasing appetite for long-term instruments, particularly inflation-protected bonds.

In contrast to equity markets, bond and derivatives markets have been subject to self regulation not official regulation. The Lamfalussy process has built a context of transparency and facilitated growth. But three recent events have undermined confidence and raised questions about protections for retail investors: (1) Losses due to various corporate credit events such as Ahold, Enron, WorldCom, and Parmalat; (2) the restructuring of Argentinean bonds that caused especially heavy losses among German and Italian retail investors; and (3) Citicorp's disruption of trading on secondary government bond markets last August. These events have given rise to calls to regulate credit rating agencies and market research and also to improve price transparency and the infrastructure for secondary markets.

Although retail involvement in fixed-income markets is less extensive than in equity markets, it is significant and growing. Transparency in fixed-income trading lags behind that of exchange-traded equities. Although the number of exchange traded bond transactions is rising, most trades occur in the more opaque, over-the-counter market. The European Commission is currently deliberating whether to expand the transparency provisions in MiFID to include fixed income instruments.

Market practitioners expressed concerns that attempts to protect retail investors could undermine the efficiency and retard innovation in the institutional market. They noted that many questions about how best to protect retail investors are still open. For example, what's the best way to educate retail investors? What kind of research should be provided? Should retail investors be given quotes on all products? Or just a few? Should brokers have obligations for suitability and best execution? Can the institutional market be segmented and permitted to innovate on its own? Many of these issues are of relevance to the US as well.

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