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

ARMONK, NEW YORK • MARCH 22-24, 2012
THE WEILL CENTER

AGENDA

THURSDAY, MARCH 22

5:25 P.M. *Renaissance Guests – Bus to the Weill Center; meet in lobby of Renaissance*

6:00 P.M. GREETINGS AND INTRODUCTION **ROOM H**

- Hal Scott, Nomura Professor and Director, Program on International Financial Systems (PIFS), Harvard Law School
- Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies

6:15 P.M. – 6:45 P.M. KEYNOTE SPEECH **ROOM H**

- Antonio de Lecea, Minister, Economic and Financial Affairs Delegation of the European Union to the U.S.

6:45-7:20 P.M. COCKTAIL RECEPTION **MAIN LOBBY**

7:30-9:30 P.M. DINNER AND KEYNOTE SPEECH **DINING ROOM**

- William Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York

9:30-10:30 P.M. COCKTAILS **MAIN LOBBY**

9:30 P.M. , 10:00 P.M. , & 10:30 P.M. *Renaissance Guests – Bus back to hotel; meet in Main Lobby of Weill*

FRIDAY, MARCH 23

6:40 A.M. *Renaissance Guests – Bus to the Weill Center*

7:00-7:50 A.M. BREAKFAST BUFFET **DINING ROOM**
**Panelists, Facilitators, and Reporters sit at reserved tables.*

8:00-9:30 A.M. BREAKFAST PANEL SESSION **DINING ROOM**

The Future of the Eurozone

- Hal Scott, Nomura Professor and Director, Program on International Financial Systems (PIFS), Harvard Law School
- Willem Buiter, Chief Economist, Citi
- Peter Kerstens, First Counselor, Economics and Finance, European Commission, EU Delegation to the USA
- Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies

9:30-9:45 A.M. REFRESHMENT BREAK **OUTSIDE OF ROOM H**

9:50-10:10 A.M. PANEL SESSION **ROOM H**

Topic 1: Macroprudential Supervision including Bank Capital

- Stefan Gavell, Executive Vice President and Head of Regulatory, Industry, and Government Affairs, State Street
- Jose Luis Guerrero, Co-Head of Global Markets, HSBC

10:15 A.M. – 11:45 A.M. SMALL GROUP SESSIONS

GROUP	ROOM	FACILITATORS	REPORTERS
1	Room H	Paul Saltzman, Mitch Coen	Brandon Becker
2	Room J	Tom Huertas, James Elles	Simon Gleeson
3	Room F	Roger Servison, Wolf Klinz	Peter McKillop
4	Dining Room 2	Kurt Schacht, Eduoard de Lencquensing	Eric Morgan de Rivery
5	Conf Room A	Ardavan Mobasheri, Michael Collins	Bill Grimes
6	Conf Room B	Emily Beizer, Steffen Kern	Diego Valiante

11:50-1:20 P.M. LUNCHEON KEYNOTE ADDRESS **DINING ROOM**

- Vitor Constâncio, Vice President, European Central Bank

1:30-1:50 P.M. PANEL SESSION **ROOM H**

Topic 2: Comparison of Derivatives Regulation in the EU and U.S.

- Tom Huertas, Partner, Ernst & Young LLP
- Florence Fontan, Head of European Public Affairs, BNP Paribas Securities Services

2:00-3:20 P.M. SMALL GROUP SESSIONS

GROUP	ROOM	FACILITATORS	REPORTERS
1	Room H	Ken Dam, Tom Krantz	Brandon Becker
2	Room J	Jim Allen, John Houston	Simon Gleeson
3	Room F	Emily Altman, Nick Reinhardt	Peter McKillop
4	Dining Room 2	Barbara Matthews, Sebastian Fairhurst	Eric Morgan de Rivery
5	Conf Room A	Crispin Waymouth, Richard Kaye	Bill Grimes
6	Conf Room B	Daniel Waldman, Penny Naas	Diego Valiante

3:20-6:00 P.M. FREE TIME

3:25 P.M. *Renaissance Guests – Bus back to hotel; meet in Weill Main Lobby*

3:20-6:00 P.M. REPORTERS MEETING **ROOM F**

5:25 P.M. *Renaissance Guests – Bus to the Weill Center; meet in lobby of Renaissance*

6:00 P.M. GREETINGS AND INTRODUCTION **ROOM H**

- Hal Scott, Nomura Professor and Director, Program on International Financial Systems (PIFS), Harvard Law School

6:10 P.M. – 6:45 P.M. KEYNOTE SPEECH **ROOM H**

- Marisa Lago, Assistant Secretary for International Markets and Development, U.S. Department of Treasury

6:45-7:20 P.M. COCKTAIL RECEPTION **MAIN LOBBY**

7:30-9:30 P.M. DINNER AND KEYNOTE SPEECH **DINING ROOM**

- Lewis B. Kaden, Vice Chairman, Citi

9:30-10:30 P.M. COCKTAILS **MAIN LOBBY**

9:30 P.M. , 10:00 P.M. , & 10:30 P.M. *Renaissance Guests – Bus back to hotel; meet in Main Lobby of Weill*

SATURDAY, MARCH 24

**Please check-out of your room before the Saturday sessions. Luggage will be stored in the front lobby of Weill Center.*

6:55 A.M. *Renaissance Guests – Bus to the Weill Center; meet in lobby of Renaissance with your luggage*

7:15-8:00 A.M. BREAKFAST **DINING ROOM**

**Panelists, Chairs, and Reporters sit at reserved tables.*

8:15-9:15 A.M. PLENARY PANEL DISCUSSION **ROOM H**

Comparison of Bank Resolution in the U.S. and EU

- Gregory Baer, Managing Director and General Counsel for Corporate Law and Global Regulatory Affairs, JPMorgan Chase & Co.
- Klaus Durrer, Global Head, Legal and Compliance Control Framework, UBS

9:20-10:20 A.M. PRESENTATION & DISCUSSION **ROOM H**

Topic 1: Macroprudential Supervision including Bank Capital

- Brandon Becker, Executive Vice President and Chief Legal Officer, TIAA CREF
- Chris Bates, Clifford Chance

10:20-10:30 A.M. REFRESHMENT BREAK

10:30-11:30 A.M. PRESENTATION & DISCUSSION **ROOM H**

Topic 2: Comparison of Derivatives Regulation in the EU and U.S.

- Patrick McCarty, Managing Director, US Government Relations and Regulatory Affairs, ICAP Americas

- Nick Collier, Global Head of Government & Regulatory Affairs, Thomson Reuters

11:30-12:30 P.M. CLOSING BUFFET LUNCH **DINING ROOM**

12:40 P.M. *Bus from the Weill Center to downtown Manhattan- drop off at Grand Central Station*

Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States, March 22-24, 2012

The tenth Europe-U.S. Symposium was held in Armonk, New York from March 22-24, 2012. Sessions included the future of the eurozone, macroprudential supervision, derivatives regulation in Europe and the U.S., and comparison of bank resolution in the Europe and the U.S. Despite the recent debt reduction agreement between Greece and its private sector creditors, concerns remained strong about the likelihood of future sovereign bail-outs. Financial institutions in the U.S. and most of Europe continued to improve, but eurozone sovereign debt and interbank markets had become highly dependent on official financing. Meanwhile, rulemaking on financial reforms in Europe and the U.S. had proceeded significantly over the previous year, although many rules remained undecided. The Symposium provided a forum to discuss the new economic and regulatory environment, as well as its likely effects on the financial sector.

Session 1: The Future of the Eurozone

The first session addressed the future of the eurozone. Participants agreed that eurozone economies faced considerable challenges, including the possibility of additional sovereign debt crises, slow growth prospects, and weakened financial institutions. Key topics of discussion involved the long-term integrity of the currency union, the likelihood of future sovereign bail-outs, the roles of fiscal and monetary policy in stabilizing the zone, and prospects for some form of fiscal union.

Integrity of Currency Union

Despite popular speculation in the U.S. about the possibility of a break-up of the eurozone, participants did not consider that a likely outcome. It was generally agreed that the political ramifications of even a partial break-up of the eurozone would be so serious that member states would not let it happen. A number of participants also invoked the economic logic, arguing that eurozone participants had all benefited significantly from lower transaction costs and that many had also benefited from having monetary union as an "anchor" that enforced responsible economic policies. They noted that any ailing economy that chose to leave the eurozone would lose its anchor, while reducing its access to external financing, inviting capital flight, and losing its right to participate in making decisions that would affect its economy even if it were outside the eurozone.

Other participants agreed that break-up was extremely unlikely, but offered an alternative explanation for why weaker members would not exit. They pointed to the sheer difficulty of exiting from a practical and legal point of view, and argued that the system should be constructed in a way that would allow for countries to exit while still respecting EU law and agreements with debtholders. Some participants also voiced the opinion that the difficulties besetting many eurozone countries would make it less attractive for others to join.

Potential for Crises

Participants agreed that one of the greatest threats to the eurozone was the likelihood of new sovereign debt crises. There appeared to be a high degree of consensus that Greece would need additional support. Participants also listed Portugal, Italy, Spain, and Ireland as potentially requiring bail-outs, although opinions were mixed as to the probability of a bailout in those countries.

Participants welcomed the agreement to expand the European Stability Mechanism (ESM), although many were skeptical that the increase would be sufficient to meet the needs of future crises, particularly if they involved Italy or Spain. Moreover, a number of participants worried that there was no mechanism in place that would be effective in preventing crises from occurring, despite the agreement on the Fiscal Compact.

Participants expressed two conflicting points of view about the inadequacies of the Fiscal Compact. On the one hand, many were skeptical that the enforcement mechanisms would be sufficient to prevent deficits and a new build-up of debt, partly because "structural deficit" had been so loosely defined and partly because some doubted that the eurozone countries would be willing to penalize major economies if they were to violate the fiscal standards. Moreover, it was pointed out that in several cases in the current crisis, including Ireland and Spain, fiscal problems had arisen suddenly and not as a result of excessive sovereign debt accumulation prior to the crisis. In such case, an agreement like the Fiscal Compact would be of little use.

A contrasting view of the flaws of the Fiscal Compact was that it would constrain governments from using countercyclical fiscal policy as they sought to meet the Compact's debt limits. Several participants were particularly unhappy about the timing of the agreement, arguing that imposing stricter new limits on deficits and debt in the midst of economic stagnation would slow the resumption of growth and thus might actually raise the risk of new crises appearing.

While there was considerable focus on the likelihood of new sovereign debt crises, participants also noted the ongoing potential for new bank failures, which in some cases might trigger or exacerbate sovereign debt woes. The potential for further bank failures was seen as deriving both from weakness in asset (especially real estate) markets and elevated unemployment. A number of participants also expressed skepticism about the risk management of banks and national banking systems, despite successive rounds of stress tests.

Weak Growth Prospects

In addition to the potential for new sovereign crises, many participants voiced concerns about weak growth prospects in the eurozone, as well as the EU in general. They focused on several different causes. From the demand side, a number of participants pointed to the lack of fiscal and monetary flexibility as weighing on eurozone growth prospects. In terms of fiscal policy, they noted that governments were being forced into retrenchment due to high debts and deficits. Not only was this situation seen as constraining access to private creditors, but the strict terms of the Fiscal Compact were seen to make countercyclical policies more difficult.

Some participants suggested that the lack of flexibility in fiscal policy was being at least partially ameliorated by more proactive monetary policy via the ECB's move to supply liquidity to troubled banking systems through long-term refinancing operations (LTROs). They expressed concern that the ECB would withdraw that support prematurely if prices started rising. Others denied that the LTROs constituted expansionary monetary policy, but saw the operations as being essential to preventing liquidity and payments problems in the banking system. Either way, many participants expressed concerns about whether weaker banks and sovereigns in the eurozone would be in a position to rely on access to private-sector financing by the end of the LTROs three-year terms.

While many participants emphasized the demand side, some participants also sought to draw attention to supply-side factors, such as rigid labor rules, that contributed to productivity gaps in the eurozone. They expressed some hope that the Euro-Plus Pact might provide incentives for improvement in potential growth in the less competitive economies of the EU.

Fiscal Union

Building on discussion of the Fiscal Compact, there was debate over the concept of a closer “fiscal union” in the eurozone. Participants acknowledged that one of the sources of instability in the eurozone was the mismatch between centralized monetary policy and decentralized fiscal policy. There was a general expectation that there would need to be higher levels of coordination of fiscal policy as well as fiscal transfers, although participants agreed that the result would not be fiscal federalism of the sort seen in the U.S. One suggestion was that transfers could be used as a way of supporting structural reforms through co-financing of policy initiatives; although the size of the EU budget would remain small relative to the zone as a whole, potential transfers could be important incentives to smaller economies.

Some participants argued that another important aspect of a more federalist system could be seen in incremental moves to expand the scope of EU financial regulators. It was generally agreed that bank regulators and deposit insurance functions in the eurozone were hampered by their establishment at the national level. Participants did not see prospects for true EU-level regulation of financial institutions. They did, however, note that EBA and other regulators were working to reduce regulatory gaps in the EU. Some also argued that the EBA’s role in stress testing of banks was an important step in reducing those gaps.

Session 2: Macroprudential Supervision Including Bank Capital

In Session 2, participants discussed macroprudential supervision. Key topics included the sources and scope of systemic risk that supervisors should be taking into account, macroprudential tools including capital requirements, supervisory structure and discretion, and the trade-offs involved in macroprudential supervision. Participants offered mixed opinions about both the potential of macroprudential supervision and its appropriate scope. Despite the relatively recent emergence of the concept of macroprudential supervision in policy agendas, a number of participants argued that it actually had a long history, albeit mixed results.

Discussion reflected considerable disagreement about what macroprudential supervision does or should entail. Some participants saw monetary policy as a central component of macroprudential supervision, while others considered it to be separate. Despite the lack of consensus over the appropriate role of monetary policy in macroprudential supervision, most discussion focused on other macroprudential tools..

Identifying Systemic Risk

A core question in Session 2 was how to understand systemic risk. For many participants, the key was the prevention of asset bubbles. Some participants conceptualized this as primarily a macroeconomic phenomenon, measured either by money supply growth, real estate price increases, or measures such as loan-to-value ratios.

Others argued that a focus on the characteristics and behavior of financial institutions was more important. From this perspective, systemic risk was mostly about excessive risk-taking and potential contagion. Many participants zeroed in on scale and interconnectedness of financial institutions.

One conclusion on which participants generally agreed was that there were some financial institutions that were systemically important, whether because of their size, their complexity, their interconnectedness, or their role in a specific asset market or set of asset markets. Participants agreed that monitoring of such systemically important financial institutions (SIFIs) should be one of the roles of macroprudential supervision, but a number of them raised questions as well.

A key issue was how systemic importance of a financial institution could be determined. Many financial regulators had focused on large banks, but it was noted that the cut-offs for systemic importance were inherently arbitrary. A more difficult problem had to do with measuring complexity and, especially, interconnectedness. One participant made a distinction between interconnectedness of credit exposures (e.g. Goldman's exposure to AIG as a CDS counterparty), which may be a serious problem, and interconnectedness of funding (e.g. the key role of clearing banks in the tri-party repo market and the possible impact of their failure), which clearly is a problem. It was noted that authorities had begun to request large amounts of information on, for example, OTC derivatives positions, but many participants expressed skepticism that there was any way to use such data effectively to gauge risk. They also noted that there was no consensus on how scale, complexity, and interconnectedness might interact in terms of increasing or decreasing the systemic impact of a given financial institution. Moreover, a number of participants pointed out that the implications of many of these measures might vary by national contexts, given differing regulation and market conditions. Some participants pointed out an additional potential flaw of the SIFI model of macroprudential supervision. They argued that systemic risk could occur as a result of herd behavior by many investors or financial institutions, regardless of their size. Indeed, they saw this as a common attribute of asset bubbles.

The problem of quantification was seen by participants as a major one. While some participants argued that useful measures had been developed to judge different forms of interconnectedness and risk, many were skeptical. Macro-level metrics such as loan-to-value ratios or credit creation were seen by many participants as too broad and too imprecise to measure systemic risk. The discussion in this regard paralleled debates over whether it is even possible to identify asset bubbles other than in hindsight. Measuring interconnectedness of financial institutions and relating it to system-level risk also struck many participants as infeasible.

Thus, despite concerns about the SIFI model of macroprudential supervision, much of the discussion came back to how best to regulate and oversee SIFIs to reduce their capacity for systemic disruption. Participants generally saw more promise in the use of comprehensive stress tests than in single metrics such as the much-criticized value-at-risk measure or even financial institutions' own estimates of their risk-weighted assets. While some found the actual practice of stress tests to be invasive and sometimes arbitrary, others pointed to what they saw as strengths of stress-testing as an approach to macroprudential supervision. Stress tests were seen as forcing financial institutions to model severe circumstances such as large-scale losses and depositor flight that held them to a common standard. Some participants also approved of the balance they struck between inflexible rules and allowing financial institutions to develop their own estimations of risk-weighted assets. By allowing financial institutions to develop their risk models while requiring them to justify those models, they saw an effort on the part of regulators to recognize institution-specific context while also preventing moral hazard. There was, however, concern about the possibility that the Fed would impose its own model, as in the most recent stress tests, or that the stress tests would not be rigorous enough, as was the case with the first eurozone stress tests.

Tools

Stepping away from how risks should be defined or measured, a major topic of debate among participants was what macroprudential supervisors should do with the information they collected. Broadly speaking, there were two vying approaches. One saw the role of macroprudential supervision as purely one of surveillance, while the other focused on implementation as well. This discussion paralleled a related debate over appropriate governance and institutional division of labor in macroprudential supervisory processes.

Participants who saw surveillance as the sole appropriate task of macroprudential supervision noted that systemic risk could arise in any of a number of ways and that different causes should lead to different policy responses. For example, excessive lending to real estate (however "excessive" might be defined) could be understood as a macroeconomic policy issue of excess credit creation or a more localized issue of inappropriate lending standards; depending on the diagnosis of the source of the risk, it might need to be handled by monetary policymakers or by bank supervisors changing rules or guidance on risk-weighting or diversification standards. Thus, these participants felt that macroprudential supervision should be separate from policy implementation.

Institutionally, this approach could be seen in most of Europe, where EU-level macroprudential surveillance was fully separated from national-level policy use of microprudential policy tools. The UK was seen as representing the opposite pole of institutional integration, in which both surveillance and implementation powers had been centralized. The emerging U.S. model under Dodd-Frank was seen as a kind of midway point in which FSOC could direct agencies (or even the Fed) to act in some cases, while being advisory in others.

Similarly, opinions on the role of central banks as macroprudential supervisors varied considerably. To some extent, this reflected views of the extent to which monetary policy was an appropriate policy tool for heading off bubbles. It also reflected the organization and functions of central banks in different jurisdictions, ranging from the UK model of centralizing authority over both monetary policy and financial supervision in the central bank, to the U.S. model in which the Fed had to share supervision functions with various federal and state regulators, to the eurozone model in which the ECB's responsibility for financial supervision was highly limited (although some national central banks were very involved). Some participants justified central bank involvement on the basis that central bank staff were more likely to be technically sophisticated and to take a broad view of the economy than more specialized regulatory or supervisory agencies.

Surveillance Issues

Participants did not see surveillance as a simple issue. In fact, many had profound questions about the analytical tools and information available to macroprudential supervisors. One set of questions, as noted above, had to do with whether the metrics available to macroprudential regulators were the right ones, as well as how to go about setting thresholds for action even if the measures were appropriate. Participants also worried that models of systemic risk and stability were not robust or well-developed. Moreover, a number of participants expressed unease about whether it was wise to rely upon even well-substantiated models when economic dynamism and financial innovation threatened to make those models obsolete. Some participants also worried that the negative effects of mistaken models could be multiplied if regulators across many jurisdictions used common models.

Beyond the questions of models, several participants raised concerns about the quality of information available to regulators. They noted, for example, that in some cases information disclosure was voluntary, and that in others financial institutions had considerable leeway in defining or measuring crucial data (e.g., risk-weighted assets). They felt that these problems of data availability and reliability would inevitably reduce the effectiveness and utility of surveillance.

Compounding all these challenges was the question of whether macroprudential supervisors in regulatory agencies and central banks should be expected to be wiser than private sector actors. Many participants were deeply skeptical that regulators would be better equipped to observe the true situation than the private sector, especially given the incentives embedded in pay scales, etc. Others saw this as a reason to entrust more macroprudential supervisory powers to central banks, which were seen as possessing better-qualified personnel than other supervisory agencies.

Moreover, participants agreed that all the problems of information were exacerbated by problems of information sharing across borders. Not only did they note that many data standards were not uniform across Europe, they noted that in some cases national laws actually *prevented* such information sharing, for example as a means of protecting proprietary secrets.

Policy Tools

Debates persisted over appropriate policy tools as well. One aspect of that debate was the issue of whether managing systemic should be understood primarily as a task for monetary policymakers. It appeared that most participants at the Symposium disagreed with that perspective, as they instead focused on traditional tools of microprudential supervision, including capital and liquidity requirements, risk accounting, comply-or-explain regimes, and transparency.

Participants noted that these tools could be either structural or dynamic in nature. For example, in terms of capital and liquidity requirements, which were seen as central to the exercise of macroprudential supervision, the approach of Basel I and II had been largely structural and rule-based. Newer elements of the capital regime, such as countercyclical capital buffers and dynamic provisioning, sought to adapt to changing economic conditions. While participants generally accepted the justification for dynamic supervision in principle, there was much less consensus as to whether regulators could accurately gauge economic cycles as well as effectively fine-tune capital or liquidity requirements. .

Participants also raised the general question of the extent to which regulatory authorities should be granted discretion in applying rules or offering administrative guidance. It was generally agreed that there were important trade-offs involved in this question. On the one hand, some participants emphasized that decision rules are rigid, and thus tend to ignore context and change. Other participants focused more on the obverse problem, that discretion gives significant power to regulators and central bankers and potentially challenges principles of democratic oversight.

Lack of clear rules to guide policy decisions would inevitably give more discretion—and thus more autonomy—to supervisors and central banks; it would also expose the supervisors to more criticism if their decisions looked wrong in retrospect. Some participants suggested comply-or-explain regimes as the best way to handle the problem of regulatory discretion, since that would provide an option by which financial institutions could innovate while still being held accountable for their actions. Similarly, it was suggested that accountability for discretionary action by regulatory or monetary authorities could be maintained through *ex post* monitoring methods such as hearings.

Finally, many participants noted that policy tools were national or at best regional, while systemic risk and crises were transmitted globally. However, mechanisms to facilitate and enforce international cooperation remained rudimentary, apart from the work of the Basel Committee.

Scope

Some participants felt that macroprudential supervision in practice ran into challenges of scope. In particular, they expressed concern that macroprudential supervision to date had shown an excessive focus on banks, without taking proper account of other types of institutions including the shadow banking system. They noted, for example, that the FSB had so far only designated particular banks as G-SIFIs (G-SIBs) and that banks dominated the national SIFI lists as well. Others were less concerned, pointing out that both Dodd-Frank and the FSB SIFI designation process explicitly authorized authorities to focus their attention on non-banks. They felt that banks were a reasonable place to start, given their centrality to the financial system, and the relatively well-developed mechanisms for evaluating and resolving banks.

A separate concern regarding scope had to do with the difficulty of cross-border coordination of macroprudential supervision. While recognizing improved communication between national authorities (particularly within Europe), as well as the creation of colleges of supervisors, there was a general feeling among participants that macroprudential supervision remained the province of national regulators, even as the global financial crisis had demonstrated the need to consider systemic risk at a global level. It was noted that the FSB and IMF had taken on that challenge in part, but that neither really had the authority or the capacity to ensure effective coordination.

Costs and Benefits of Macroprudential Supervision Regimes

Overall, participants struggled with three basic challenges in their discussions of macroprudential supervision, without coming to consensus. First, would it actually reduce systemic risk in the global financial system? A number of participants expressed profound skepticism, arguing that the current state of knowledge about risk identification and remediation did not provide a clear guide for supervisors, and that granting them additional discretion to use their own judgment would be unwarranted. Moreover, these participants worried that continuing to ratchet up oversight over financial institutions that were already highly regulated would simply increase incentives to shift financial activities—and therefore risk as well—to less regulated activities in the shadow banking sector. Others had more optimism about the potential for macroprudential supervision to improve financial stability. They noted that many of the elements of macroprudential supervision were already in place, and suggested that broadening the perspectives of microprudential supervisors and central banks as to what constituted risk could improve their performance. They also felt that more effective regulation could prevent migration of financial risk and activities into shadow banking.

Second, what were the costs and benefits of strengthening macroprudential supervision regimes? There was a debate among some participants as to whether regulators seriously considered the costs of the new rules and regulations that had been imposed to prevent a recurrence of the perfect financial storm of 2008. For example, some participants strongly criticized rulemaking under Dodd-Frank for not making sufficient (or in many cases, any) efforts to calculate added regulatory burden for financial institutions. Others disagreed, arguing that serious efforts had been made to do so, but that it was impossible to quantify the costs and benefits. More fundamentally, a number of participants saw the core issue as the relative values societies should assign to stability versus growth. Some were deeply concerned about the negative impacts on financial innovation and what they saw as the willingness of the financial sector to provide risk capital for economic growth. Others felt that the effects of large-scale financial crises were so profound that the need for prevention or at least mitigation of future crises overrode the costs to financial institutions of increased macroprudential supervision and more stringent capital requirements, even if those policies reduced growth.

Finally, how should democracy and accountability be addressed in these debates? Participants recognized that many of the costs of crises were borne by the real economy, while the immediate benefits of financial innovation were concentrated in the financial sector. At the same time, they worried that populist politics would lead to bad policies. Some aspects of the Dodd-Frank Act, such as the Volcker Rule, came under particular criticism in this regard. Some European policies also came under fire, including the Vickers Commission's recommendation to implement ring fencing as a structural means for macroprudential policy, as well as ongoing proposals for financial transaction taxes.

Session 3: Comparison of Derivatives Regulation in the EU and U.S.

Session 3 assessed ongoing changes in derivatives regulation in the EU and U.S. It focused in particular on rules regarding central clearing of derivatives and on whether new regulations would hinder or facilitate cross-border derivatives trading. Two key questions for the session were the effects that central clearing would have on liquidity and systemic risk.

Convergence and Divergence between the EU and U.S.

Over four years after the assisted takeover of Bear Stearns, EU and U.S. regulation of derivatives had changed significantly in response to both internal and international processes. Significant new layers of regulation had been proposed and the shape of the new system appeared ready to emerge. Despite differing political and market contexts and calendars for reform, participants noted significant convergence in principles between the EU and U.S. Nonetheless, differences in details of regulation created questions about the ability of market players from the two sides of the Atlantic to operate in each other's turf, raising concerns about liquidity and risk management.

Many participants were impressed at the extent to which the EU and U.S. had converged in principle with regard to derivatives regulation. They noted the role of the FSB and transatlantic communication in facilitating this convergence, although some also pointed to *de facto* agenda-setting by the U.S., which had moved more quickly in passing the basic reform legislation. Convergence was most striking in three broad areas. One was the principle of central clearing and standardization to reduce counterparty risk and improve liquidity. The second was the principle of reporting all trades of both standardized and bespoke derivative products to trade repositories in order to improve transparency and disclosure. The third was efforts to reduce barriers created by differing national systems through harmonization (e.g., the agreement to create Legal Entity Identifiers, or LEIs), mutual recognition, national treatment, and coordination at the transatlantic and G20 levels.

Despite the convergence in principle, a number of participants agreed that the devil remained in the details, which had the potential to limit international derivatives markets. Three major sticking points received much of the focus in Session 3: national treatment, timing gaps, and extraterritoriality.

Participants welcomed the stated principles of national treatment and mutual recognition, but noted the existence of several obstacles. They noted that many of the standards for according mutual recognition had yet to be finalized. Some also expressed doubt that national politics in the wake of a crisis would allow for true equal treatment of foreigners—for example, they worried that in the event of a failure of a clearinghouse, many jurisdictions would be tempted to privilege their own citizens and resident firms in terms of bail-outs and losses.

With regard to timing, a number of participants lamented that the U.S. Congress had enacted Dodd-Frank without the full benefit of G20 and transatlantic consultations. In addition to creating substantive differences in a number of areas of financial regulation, it meant that significant gaps existed between expected implementation of rules, although the delays in Dodd-Frank rulemaking had somewhat reduced the length of the gaps. Some participants worried that the timing gaps would provide opportunities for regulatory arbitrage. Although these arbitrage opportunities would be temporary, there were concerns that permanent advantages might arise for some clearinghouses that were able to exploit first-mover advantage.

A third major challenge was extraterritoriality. European participants were dismayed by provisions in the new U.S. law that had the potential to force any entity trading derivatives through U.S. exchanges and clearinghouses (central counterparties, or CCPs) or even with U.S. counterparties to be subject to U.S. laws or equivalent foreign laws. Draft EU legislation had responded with similar equivalence provisions. While regulators on both sides sought to offer reassurances that the problems would be solved through negotiation and mutual recognition, many participants worried that extraterritorial provisions would significantly reduce cross-border derivatives trading, and therefore market liquidity.

There were also a variety of smaller, more concrete issues. Some of these were legal in nature, such as distinctions between execution and trading. Differing margin and collateral rules across jurisdictions also threatened to raise costs for U.S. actors to do business in the EU and vice-versa. It also remained unclear whether EU regulators would follow the U.S. lead in terms of exemptions from clearing requirements (e.g., of exchange rate swaps) and whether rulemaking on legal requirements for operating clearinghouses (membership, governance, and access) would differ in significant ways. While regulators on both sides of the Atlantic continued to emphasize that these problems would be surmounted, some participants worried about whether good faith would go far enough in lowering the legal and cost barriers between jurisdictions to revive cross-border markets.

Central Clearing and Global Financial Stability

The bulk of discussions on derivatives regulation was focused on centralized clearing through CCPs. Participants reviewed the role, operations, and regulation of CCPs under the reforms. They also discussed at length the likelihood and potential impact of the failure of a central counterparty, as summarized in the following section.

Legislation to promote central clearing was introduced in both Europe and the U.S. as a response to the concern over a chain reaction of failures that could result from the failure of a major counterparty to honor its out-of-the-money positions, as in the case of AIG. Furthermore, during the global financial crisis, concerns over the solvency of counterparties had led to margin calls and fire sales that disrupted markets and forced a number of players in the derivatives markets into bankruptcy. In contrast, liquidity and price formation in exchange-traded securities, which are centrally cleared, were never in question, despite significant price drops in many instances. By shifting as much derivatives trading as possible to clearinghouses, regulators sought to increase the stability of the system, while maintaining liquidity and improving regulators' understanding of risk in the marketplace.

Symposium participants recognized several potential advantages for market participants from the shift to centralized clearing. Chief among these was improved management (albeit not elimination) of counterparty risk. Well-regulated and well-capitalized clearinghouses run by leading financial institutions would utilize multilateral netting operations and could be expected to reduce the likelihood that the failure of a single market participant could cascade through the global system.

Participants generally approved of the new requirements for reporting to trade repositories. They saw this as an essential means for regulators to track market developments and keep an eye on risks, at relatively low cost to market actors. There were, however, some concerns on specifics. Several participants reserved judgment on the actual costs of trade reporting for market actors, noting that different jurisdictions could come up with different reporting requirements and that each trade could conceivably need to be reported to multiple authorities depending on the nationality of the counterparties and the location of clearing. They also questioned whether regulators had the ability or a clear method of making sense of the enormous amount of trading data that they would be collecting. Some also suggested that data confidentiality could be a concern. Some advocated that there should be one trade repository per asset class of OTC derivatives.

Participants agreed that the emphasis of regulators on standardization of derivative products was meant to boost liquidity, improve price transparency, and lower costs of basic products for end-users. However, a number of participants expressed considerable skepticism about these justifications, particularly the expectation that costs would drop. They argued that many end-users benefited from specialized derivatives that did not lend themselves to standardization. If the prices of non-standardized OTC derivatives rose as a result of the reforms, they reasoned, end-users would be forced to choose between standardized derivatives that did not fit their needs and higher-cost bespoke derivatives that did fit their needs. Other participants were less concerned. They argued that the change was not as great as it appeared. They noted that standardization and centralized clearing for products like interest rate swaps had been on the increase in any event, even as markets for more specialized derivatives had in many cases dried up.

A number of participants raised additional concerns about aspects of the new rules. Some argued that the expected standards for clearinghouses, particularly in Europe, might encourage the formation of many CCPs, leading to market fragmentation that could reduce liquidity and raise costs. Others felt that market fragmentation would not be a problem due to the likelihood of economies of scale, although they recognized the possibility of fragmentation along national lines if international cooperation failed to facilitate cross-border trading.

Participants also raised the issue of how the new rules might directly affect costs for derivatives across the board. Clearinghouses would face strict capital-adequacy, liquidity, and reporting requirements, the costs of which would inevitably be passed on to clients. Basel 2.5, for example, had already set stricter collateral requirements for OTC derivatives, albeit lower requirements for centrally than bilaterally cleared ones, and national regulators would be in a position to strengthen those requirements.

Participants had differing predictions as to possible results if costs proved to be very high for clearinghouses. Some suggested that it could lead to a consolidation of clearinghouses, reducing options for investors and end-users. Others worried that clearinghouses that found themselves losing business or becoming unprofitable might try to follow a low-cost strategy that could lead to a race to the bottom in terms of managing their own risk or monitoring that of their clients.

Central Counterparty Default Risk

The biggest concern about the shift to centralized clearing was the possibility of a CCP default. Participants noted that under the new regulations, default risk was not being eliminated, but rather transferred to a single "super-SIFI." Practically speaking, CCPs would become essential market infrastructure that could not be allowed to fail. Thus, participants agreed that creating effective supervision and planning for resolution on a going concern basis would be indispensable features of the reformed financial system.

While most participants saw the risk of CCP failure as quite low, based both on business model and many decades' history of clearinghouse operations, several emphasized that the dangers of such a failure would be far-reaching. Some even argued that rules requiring central clearing of derivatives should not be implemented until all potential complications of a failure had been worked out. Others felt that, while it was an important issue, it was not an urgent one and that the risks could be largely mitigated under the current framework.

CCPs were seen to face several forms of risk. The main issue was concentration risk, where a CCP failure could be triggered by a major derivatives trader being unable to meet obligations to an extent that exceeded the capital available to the clearinghouse. A number of participants countered that sufficient safeguards were already in place. With regard to a failure of members, it was noted that CPSS/IOSCO standards called for stress tests based on the premise that a clearinghouse should be able to withstand the failure of its two largest members. Similarly, risk management standards of diversification would likely address the problem of even a major derivatives trader failing (analogous to AIG). An alternative scenario would be if capital calls in a CCP led to the failure of a member institution, which could then have contagion or cascade effects separate from the direct impact of the clearinghouse failure itself.

The major concern for many was that risk management standards would not be faithfully implemented, such that either poor-quality market actors would be allowed to use the clearinghouse or that the CCP might misjudge the riskiness of collateral. Some participants warned that one way in which that could occur would be if regulations restricted CCP members from excluding (or at least imposing differential collateral requirements on) participants they saw as uncreditworthy. They saw this as a live possibility, since end-users and buy-side players like hedge funds had expressed concerns about being excluded from access to and governance of CCPs. Those users and some policymakers saw access as an issue of fairness, since new regulations would dictate that derivatives be clear centrally in most cases. Indeed, the CFTC has proposed lowering the minimum capital requirements for clearinghouse membership to promote more open access.

Other concerns had to do with the possibility of a lack of segregation of assets by CCP members or illiquidity caused by mismanagement of treasury assets, primarily the default fund. One participant descried this risk as the mismanagement of the "maturity transformation function." He noted that most CCP operating profits come from investing treasury assets in medium-term government bonds, since trading fees are typically kept low for the benefit of members. In theory, the emergence of a steep yield curve could have a negative impact on the CCP default fund at exactly the time when it was needed. Overall, while it was relatively easy for participants to come up with scenarios of stress on a CCP, few thought that an actual failure in a major market economy was likely.

Given the strict standards for collateral, capital, liquidity, and stress testing, a CCP failure would almost certainly involve a serious failure of supervision.

Waterfall Protection

A number of participants felt that the existing system (known as the “waterfall”) was sufficiently robust to handle even an extreme event, as seen in the CPSS/IOSCO stress test standards. Under the current system used by clearinghouses in Europe and the U.S., the first line of defense against the failure of a clearinghouse participant would be collateral in the form of initial and variation margin. If that collateral proves to be insufficient to reimburse contract-holders, the next line of defense would be the CCP’s default fund, whose minimum level is mandated by the CCP’s regulator. If the default fund is insufficient, the next step would be the CCP’s paid-in capital. Again, minimum capital adequacy is mandated by the regulator. Finally, if CCP capital were to be fully depleted, members would be responsible to cover the losses to some level.

That final level was one of two places where participants saw ambiguities arising, as standards were not yet clear and consistent about how far individual members’ obligations went. It was noted that in many cases there was an assumption of unlimited obligation (“to the last drop”). Some Symposium participants were unhappy with the adoption of such a standard, however, arguing that it would reduce some of the attraction of being a clearinghouse member. They felt that it would be particularly inappropriate if CCPs were not allowed to set their own standards for potential participants.

A major question was the potential role of the central bank if the clearinghouse were in trouble. There appeared to be a general consensus among many Symposium participants that, as SIFIs, clearinghouses should have access to emergency liquidity in order to continue operating. However, it was unclear whether direct intervention would be possible in either Europe or the U.S. In the eurozone, for example, the ECB could not intervene directly, although national central banks may be able to do so at their own risk. But participants pointed out that even if direct borrowing from the central bank were impossible, CCPs would likely be able to borrow indirectly if their member banks drew on central bank liquidity facilities.

Based on these ambiguities, some participants argued that mandatory clearing should be postponed until these questions were fully settled. While this appeared to be a minority position, participants agreed that the ambiguities should be addressed and risk management of CCPs should be closely monitored going forward.

Session 4: Comparison of Bank Resolution in the U.S. and EU

Session 4 focused on resolution of failed banks, which participants agreed was crucial to managing future crises. Participants discussed bank resolution systems in the U.S. and EU, as well as the problem of cross-border resolution. They recognized that there remained considerable variation among national systems and that resolution and recovery plans ("living wills") remained untested. In general, participants positively evaluated the progress to date, particularly in the U.S., while maintaining concerns about the effects of panics and the management of cross-border bank failures.

Bank Resolution in the U.S.

Discussion of bank resolution in the U.S. focused on the specific challenges of resolving banking institutions with a holding company structure, which participants saw as the major weakness of the pre-crisis bank resolution system. Whereas the FDIC resolution process for domestic banks was seen as well-developed and effective, the crisis had shown the difficulties of managing financial conglomerates as going concerns when holding companies became insolvent or unable to access liquidity. Thus, one of the key provisions of Dodd-Frank was to set new rules for managing the failures of financial conglomerates, as well as to require SIFIs to prepare living wills to enable orderly liquidation.

A key emphasis of FDIC orderly liquidation authority of systemically important bank holding companies under Dodd-Frank was keeping the institution functioning as a going concern, by not putting subsidiaries through bankruptcy, providing a single point of entry for recapitalization, and providing temporary liquidity to the banking entity. The system was also designed to avoid use of taxpayer money to bail out financial institutions; in this regard, participants noted both the SIFI surcharge and provisions for *ex post* assessments in the event that deposit insurance funds were to prove insufficient.

Participants described living wills as a key mechanism for ensuring both the going concern and the "no taxpayer money" goals. Some were skeptical of the idea that bail-outs could be completely eliminated. They worried that living wills would be costly to design, would become quickly obsolete as business opportunities changed, and could lead to reorganizations of business units in a way that would reduce synergies and innovation, without necessarily improving the security of the system. Other participants disagreed, including several who had been involved in the creation of living wills on either the bank or the regulator side. They described the process of creating a living will as a useful exercise in contingency planning that clarified risks as well as potential organizational and procedural weaknesses within the bank. They felt that, by involving regulators and bank personnel from throughout the business, the process of creating the living will significantly increased preparedness for how to deal with an actual crisis.

Part of the session involved walking through a resolution of a U.S.-based SIFI bank. The presentation sought to map out how the bank would survive a loss of assets and liquidity that significantly exceeded anything faced in the crisis. While shareholders of the holding company in the crisis scenario were wiped out and senior debtholders of the holding company took a haircut, the subsidiary banks could go on operating. Participants appeared for the most part to be favorably impressed by the exercise, although several noted that such plans were untested in practice. It was also noted that the proposed resolution only worked where banking organizations used bank holding companies, which were less common in Europe. Pointing out that the U.S. resolution authority essentially made all bank debt bail-in-able, some argued that senior debt would be less attractive than Swiss-style contingent capital.

Bank Resolution in Europe

Discussion of bank resolution in Europe began with a recognition that there was not yet anything approaching uniformity of bank resolution systems across the various EU and non-EU countries. Indeed, participants emphasized the differences among legal systems, bankruptcy regimes, and supervision of financial institutions that they felt contributed to the issue of fragmentation. They also saw the quality of resolution regimes and bank supervision as varying widely.

There was an extended discussion of Switzerland's bank resolution regime as an example of one of the more highly-developed systems. The Swiss regime built on a deposit insurance and bank resolution law that had been established in the 1990s. With the global financial crisis, it became apparent that a special regulatory regime would be required for UBS and Credit Suisse, whose global scale far outstripped the ability of the deposit insurance system or macroeconomic authorities to bail out. The resulting "too big to fail" legislation called for significantly higher capital requirements, including contingent capital with pre-defined triggers (based on levels of capital loss) under formal recovery and resolution plans. It also explicitly rejected ringfencing.

Despite national differences across Europe, participants noted efforts to improve the uniformity and effectiveness of less-developed regimes. An important element in these efforts was the drafting of a common EU framework for resolution regimes. While the framework was still in progress, knowledgeable participants stated that it was expected to follow the same broad principles as set by the FSB and followed in the U.S. Banks would be expected to prepare resolution and recovery plans that would align business structure with the goals of the plans. National governments would also be expected to create resolution regimes (distinct from standard bankruptcy procedures) that would utilize bridge banks and other tools in order to prevent disruption of markets and potential contagion. Finally, the framework was seen as likely to mandate creation of cross-border colleges of resolution authorities to allow for "group resolution." Nonetheless, a number of participants expressed skepticism that EU countries had progressed far enough in ensuring smooth cross-border resolution of regional banks; thus, they felt that it would be particularly important to strengthen national supervision, deposit insurance, and resolution regimes across Europe.

International Cooperation

In general, cross-border cooperation was seen as a major weak spot in terms of resolution of international banks, as seen in the phrase that many participants used of "international in life, national in death." The differences among national resolution regimes were seen to constitute one barrier, as noted above. Participants also noted that national authorities would have strong incentives to ringfence capital and assets in the event of a large-scale bank failure in order to protect their citizens and domestic firms, and that this incentive could overwhelm preexisting agreements between national regulators.

Several participants did describe substantive progress in international cooperation. For example, the FSB had successfully designated the first set of G-SIBs and was working on designation of non-bank G-SIFIs. The FSB had also developed the "Key Attributes of Effective Resolution Regimes for Financial Institutions," which called for each country to develop orderly resolution authority that would allow troubled banks to continue to operate as going concerns and created guidelines for living wills and resolution procedures.

Nonetheless, cross-border resolution remained a sticky problem, despite the creation of colleges of supervisors, improved communications between national regulators, and the increasing prevalence of living wills. While opinions varied as to the likely effectiveness of these measures in preventing the "international in life, national in death" problem, there appeared to be a general consensus that the creation of effective and roughly functionally equivalent resolution regimes at the national level would be a precondition for eliminating uncertainty in large-scale cross-border resolutions.

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