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

The Weill Center, 188 King Street, Armonk, New York
APRIL 7-9, 2016

AGENDA

Thursday, April 7

5:35 p.m. & 5:50 p.m. *Renaissance Guests – Bus to the Weill Center; meet in front of the Renaissance Hotel*

6:00-6:40 p.m. **COCKTAIL RECEPTION** *Main Lobby*

6:40-6:45 p.m. **GREETINGS** *Dining Room*

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

6:50-8:00 p.m. **KEYNOTE ADDRESS** *Dining Room*

- Tara Rice, Deputy Assistant Secretary for International Financial Stability, U.S. Department of the Treasury
- Mario Nava, Director, Regulation and Prudential Supervision of Financial Institutions, European Commission

Introduced by: Hal S. Scott, Nomura Professor and Director, PIFS, Harvard Law School

8:00-9:30 p.m. **DINNER** *Dining Room*

9:30-10:30 p.m. **AFTER DINNER COCKTAILS** *Main Lobby*

9:35 P.M. 10:05 P.M, & 10:30 P.M. *Renaissance Guests – Bus back to hotel; meet in Main Lobby of Weill*

Friday, April 8

7:15 a.m. & 7:40 a.m. *Renaissance Guests – Bus to the Weill Center- Meet in front of Renaissance Hotel*

7:30-8:15 a.m. **BREAKFAST** *Dining Room*

8:20-8:55 a.m. **PANEL SESSION** *Room H*

What is the future of large global banks?

- Greg Baer, President, The Clearing House Association
- Emiliano Tornese, Division of Financial Stability, European Commission

9:00-10:20 a.m. **SMALL GROUP SESSIONS**

Group	Room	Facilitator	Reporter
1	Room H	Alan Houmann	Eric Morgan de Rivery
2	Room F	Brandon Becker	Simon Gleeson
3	Room J	Stephen Albrecht	Ed Nalbantian
4	Room A	Andrei Kirilenko	Bill Grimes
5	Room B	David Freeman	Panos Delimatsis

10:20-10:35 a.m. **REFRESHMENT BREAK**

10:35-11:05 a.m. **P A N E L S E S S I O N** *Room H*

Divergence between US and EU regulations (focus on CCPs, Capital)

- Kay Swinburne, MEP, Member of Economic and Monetary Affairs
- Eric Pan, Director, International Affairs Office, US Commodity Futures Trading Commission

11:10-12:25 p.m. **S M A L L G R O U P S E S S I O N S**

Group	Room	Facilitator	Reporter
1	Room H	Richard Kaye	Eric Morgan de Rivery
2	Room F	Paul Saltzman	Simon Gleeson
3	Room J	Simon Jowers	Ed Nalbantian
4	Room A	Robin Maxwell	Bill Grimes
5	Room B	Nick Reinhardt	Panos Delimatsis

12:30-1:40 p.m. **L U N C H A N D K E Y N O T E A D D R E S S** *Dining Room*

- Andreas Dombret, Member of the Executive Board, Deutsche Bundesbank

Introduced by: Hal S. Scott, Nomura Professor and Director, PIFS, Harvard Law School

1:45-3:10 p.m. **P L E N A R Y S E S S I O N** *Room H*

Liquidity in the private fixed income market

- Barbara Novick, Vice Chairman, BlackRock (moderator)
- Paul Hamill, Global Head of FICC, Citadel Strategies
- Shane Worner, Senior Economist, IOSCO
- Martin Moloney, Head of Markets Policy Division, Central Bank of Ireland

3:15 p.m. *Renaissance Guests – Bus back to hotel; meet in Weill Main Lobby*

3:15-6:10 p.m. **R E P O R T E R S M E E T I N G / F R E E T I M E** *Room F*

5:45 p.m. & 5:55 p.m. *Renaissance Guests – Bus to the Weill Center; meet in front of the Renaissance Hotel*

6:15-6:45 p.m. **K E Y N O T E A D D R E S S** *Room H*

- Sylvie Matherat, Chief Regulatory Officer and Member of the Management Board, Deutsche Bank AG

Introduced by: Hal S. Scott, Nomura Professor and Director, PIFS, Harvard Law School

6:45-7:15 p.m. **C O C K T A I L R E C E P T I O N** *Main Lobby*

7:20-9:30 p.m. **D I N N E R A N D K E T N O T E A D D R E S S** *Dining Room*

- Tom Harrington, Chief Information Security Officer, Citigroup, Inc.

Introduced by: Hal S. Scott, Nomura Professor and Director, PIFS, Harvard Law School

9:30-10:30 p.m. **A F T E R D I N N E R C O C K T A I L S** *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, April 9

7:15 a.m. & 7:40 a.m. *Renaissance Guests – Bus to the Weill Center- Meet in front of Renaissance with your luggage*

7:30-8:15 a.m. **BREAKFAST** *Dining Room*

8:20-9:00 a.m. **KEYNOTE ADDRESS** *Dining Room*

- Dr. Chiara Zilioli, Director General, Legal Services, European Central Bank

9:05-10:05 a.m. **PRESENTATION & DISCUSSION** *Room H*

Reform of secondary market structure for equities

- Hal Scott, Nomura Professor and Director, PIFS, Harvard Law School
- Adam Nunes, Head of Business Development, Hudson River Trading LLC
- Jeff Brown, Senior Vice President, Legislative and Regulatory Affairs, Charles Schwab & Co., Inc.

10:05-10:15 a.m. **REFRESHMENT BREAK**

10:20-11:15 a.m. **PRESENTATION & DISCUSSION** *Room H*

What is the future of large global banks?

- Stefan Gavell, Executive Vice President and Head of Regulatory, Industry, and Government Affairs, State Street
- Chris Bates, Partner, Clifford Chance LLP

11:15-12:05 p.m. **PRESENTATION & DISCUSSION** *Room H*

Divergence between US and EU regulations (focus on CCPs, Capital)

- Barbara Matthews, Managing Director, KPMG
- Cristiano Zazzara, Managing Director, Head of Global Risk Services Relationship Management, S&P Global Market Intelligence

12:10-12:45 p.m. **CLOSING BUFFET LUNCH** *Dining Room*

12:50 P.M. *Buses from the Weill Center to JFK and Grand Central Station*

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

The Harvard Law School Program on International Financial Services' 15th Europe-US Symposium was held on April 7-9, 2016 at the Weill Center in Armonk, NY. Sessions addressed the future of large global banks, divergence between EU and US regulation—particularly with regard to clearinghouses, liquidity in the private fixed income market, and reform of secondary market structure for equities. Participants applauded the recent EU-US agreement on equivalence of regulatory regimes for central clearing of derivatives, but saw continuing challenges for cooperation on resolution and recovery for central clearing parties. There were also concerns expressed about continuing populist resentment against financial institutions, which participants worried could stifle cross-border financial activity and resilience in the financial system.

Session 1: What Is the Future of Large Global Banks?

In Session 1, participants discussed the future prospects for large global banks. They considered factors that would likely ensure continued demand for large global banks, as well as incentives to reduce their size, scope, and international activities. Key considerations were regulatory burden and technological developments. Many participants expected to see greater variation among the large global banks that would remain, with greater specialization along functional or geographical lines.

Shifting Business Models

Most participants agreed that demand for the services of large global banks would not disappear. Multinational companies would continue to benefit from the international reach and functional breadth that only a global financial conglomerate could provide. Cross-border payments and account management were seen as a particularly crucial function that international banks could fulfill. Participants also noted that multinational firms needed structured financial products to manage currency and other risks across borders.

In addition, despite political and regulatory efforts that sought to limit the size and complexity of major financial institutions, new regulations also created incentives for at least some financial institutions to remain large. For example, a number of participants argued that there were economies of scale in some areas of increased compliance costs. A similar argument was made concerning economies of scale in information technology, where the demands of risk management and cybersecurity required large-scale investments even for smaller players.

Nonetheless, participants also observed that retrenchment was a reality among many of the previously active global banks. They noted a variety of financial institutions that had significantly downsized, including by divesting entire business lines. In addition, many banks had reduced their foreign operations, either in order to focus on a smaller number of profitable foreign operations, or as a conscious effort at re-domestication. The re-domestication strategy was seen as being particularly prevalent among banks based in smaller economies, such as Iceland and Switzerland, where regulators had expressed particular concern about their ability to fund and manage large-scale failure. Throughout the EU and U.S., moves to downsize or specialize were also seen even among some financial institutions that had grown in scope, size, or geography as a result of mergers and acquisitions in the financial crisis or immediate post-crisis years—as some participants put it, “the era of consolidation is over.”

Role of Regulation

Post-crisis regulation was cited by many participants as a primary reason for retrenchment by banks. Stricter capital adequacy requirements would make low-yielding activities unprofitable; moreover, some banks facing higher capital-asset ratios would make the choice to reduce assets instead of (or in addition to) increasing capital. It was noted that these choices often depended on size and jurisdiction. In particular, the threat of designation as a SIFI might make a financial institution intentionally downsize, as costs would be increased by higher capital standards, resolution and recovery plans, and other aspects of enhanced regulation. Similarly, banks based in jurisdictions that imposed particularly high capital requirements on SIFIs, would have particular incentives to downsize, eliminate less-profitable business lines, or reduce their international activities.

Capital rules were only one of a number of regulatory issues noted by participants. Many spoke of the overall weight of regulatory burden. To add to the burden, jurisdictions around the world had expanded regulation and increased penalties, but with only limited coordination. Thus, internationally-active banks faced additional challenges in following overlapping and sometimes even contradictory rules across multiple jurisdictions. Large global banks had to confront the sheer volume and cumulative effects of post-crisis regulation, which was further compounded by SIFI and GSIB regulation.

Participants also expressed concern about ring-fencing. National ring-fencing—such as requiring that regulatory capital or TLAC be held within the host jurisdiction—was seen to be a common response of regulators who were nervous about their ability to protect taxpayers from financial institution failures emanating from abroad. The U.S. was only one of a number of jurisdictions trying to ring-fence the capital of subsidiaries of foreign banks. While ring-fencing would not increase the total amount of capital needed by a large global bank, it would significantly affect the bank's ability to manage and deploy capital, reducing some of the benefits of centralized capital management and diversification of risk. Banks also faced ring-fencing along functional lines, in the form of the Volcker Rule, Vickers Rule, and other national-level efforts. This was seen by many participants as reducing the benefits of the diversified business practices of universal banks.

A particular concern at the Symposium was what a number of participants identified as the "fat-tail risks" of extremely large fines for violations of know-your-customer (KYC) and anti-money laundering rules, market manipulation, or tax evasion. Several argued that it was difficult for even a very sophisticated large bank to control all its offices, particularly those in foreign jurisdictions. The sheer size of the fines (e.g., the $1.9 billion judgment in 2012 against HSBC for the activities of its Mexican subsidiaries) would make financial institutions eager to divest themselves of less-profitable subsidiaries and branches that might come under scrutiny. Participants pointed out that KYC was particularly difficult in emerging markets where banks lacked the ability to track the final recipients of transferred funds. Thus, banks' desires for de-risking was leading them to withdraw from emerging economies, especially in Africa. Many participants felt that if banks withdrew, criminal and terrorist financing would simply shift to less-traceable non-bank methods of transferring funds, while weakening the formal financial systems of the affected countries. In contrast, at least one participant suggested that banks might be using the costs of KYC regulation as an excuse to leave marginal businesses and expressed concern that this behavior was hurting emerging economies. However, most participants appeared to reject this criticism, laying the blame instead on the unpredictable and potentially massive costs associated with KYC.

There was some discussion as to whether some of the negative effects of perceived overregulation might be addressed by regulators and policymakers. Few considered political conditions in the U.S. and Europe to be conducive to efforts to reduce regulations and penalties for banks; rather, participants agreed that populism was on the rise in both, characterized at least partly by a profound distrust of banks. However, some participants argued that there were might be real opportunities to rethink the more onerous aspects of regulation and enforcement. This was partly because there was a sense among many participants that the post-crisis cycle of reregulation was coming to an end as the final pieces of the G20 agenda were finalized in the U.S. and Europe. Also, even if legislation to relieve pressure on financial institutions was unlikely in the current political climate, it was noted that regulators and supervisors could take costs into account in exercising their discretion over interpretation and enforcement.

Differences between US and Europe

While some of the specific regulatory differences between the U.S. and Europe were addressed in Session 2, participants discussed several general cross-border issues in Session 1.

Participants agreed that one important challenge for banks in both Europe and the U.S. resulted from regulatory fragmentation. For major banks operating the U.S., that partly meant dealing with multiple functionally distinct regulators. However, participants also noted considerable gray areas of overlap between various regulators for SIFI banks, including the Fed, OCC, SEC, CFTC, CFPB and state regulators. Banks operating in Europe in some ways faced a less complex regulatory and supervisory landscape, given EU-level policies and regulations, and (to some extent) enforcement. The new role of the ECB in supervising large Eurozone banks was resulting in additional simplification. However, participants pointed out that national laws implementing EU policies could still vary considerably by country, as could enforcement by national authorities or central banks. Furthermore, in some areas of law of direct relevance to banks, such as bankruptcy, there was very wide divergence even at the level of principles and definitions.

Participants also noted significant differences in policymaking. In the U.S., the federal legislative process was seen by many participants as structurally more streamlined than in the EU, which could lead to faster legislative responses. . Moreover, U.S. laws tended to leave a great deal of discretion over how to implement laws to regulatory and supervisory bodies. In the EU, in contrast, gaining sufficient support to pass legislation was seen as much more procedurally complex and time-consuming, and resulted in far less discretion to regulators. Thus, some participants argued that it was possible for the U.S. system to react more quickly and flexibly to changes. But if the EU were unwilling to accept the U.S. as first-mover, cooperation could become very difficult because regulators would have little scope to try to find common ground with their U.S. counterparts if regulations diverged in a given area.

Several participants expressed a preference for aspects of EU policymaking. They argued that European policymakers (whether at the Commission, Parliament, or in a regulatory body) were more willing to consult with the private sector and pay attention to the costs and benefits of regulations under consideration than their counterparts in the U.S. As one example, they pointed to recent debates over regulations that sought to take into account the effects on jobs and growth. Others were skeptical of this assessment, however. They felt that at least some U.S. regulators were quite open to considering trade-offs between costs and benefits, and that their discretionary powers better allowed for mid-course corrections.

Given the importance of the U.S. and Europe in the global financial system, participants expressed frustration at the continued challenges of convergence or even of substituted compliance. Thus, there was considerable discussion of how to bridge the gap. While much of the discussion of specifics is summarized in Session 2 below, some participants argued that there was some scope for reducing some of the differences in financial regulation. For example, it was suggested that harmonization of definitions (e.g., of capital and leverage) should be feasible. Also, some participants argued that it would be both possible and helpful to have agreed standards for banks' stress tests.

Impact of Fintech

In addition to regulation, participants discussed the development of financial technologies as a force that was likely to impact large global banks. There were varying points of view as to whether technological change would favor incumbent or new players, and how it would affect the business models and structure of the large global banks.

A number of participants argued that fintech offered considerable opportunities for large banks. They reasoned that fintech would allow for significant cost-cutting in many areas, and that there were likely to be economies of scale in the introduction and use of financial technologies. Meanwhile, large banks would have an advantage relative to smaller financial institutions in making the type of large investments needed to keep up with technological development. Some participants also suggested that the scope and scale of large banks' transactions would create significant value in the form of data, which could be used for purposes well beyond credit analysis.

Other participants were skeptical that large banks—or even the general category of banks as currently defined and regulated—would be the major beneficiaries of fintech. They saw fintech as disruptive to existing banking models. Thus, they argued that the major contest would not be between large and small banks, but rather between banks and other providers of technology or data services.

At the retail level, a number of participants noted that non-bank payments solutions including PayPal, Apple Pay, China's Alipay, and Kenya's M-PESA were already increasingly popular among users, and were likely to become more so over time. They speculated about the effect a large-scale migration of customers away from traditional bank deposits toward stored value accounts on such platforms would have on traditional banks. There were mixed views on the importance of this sort of disruption. Some participants argued that services such as PayPal and Apple Pay were simply retail interfaces that relied on a backbone of services provided by banks, and that therefore they should not be seen as particularly disruptive. Others disagreed. They argued that, even if such services continued to rely on banks for settlement and credit processing (which they saw as by no means assured), the banks could get stuck with the least profitable parts of the transaction, competing to process payments for name-branded tech firms.

In principle, fintech firms could eat into a variety of other bank functions. Crowdfunding and person-to-person lending could supersede banks' role as evaluators and providers of credit. M-PESA had already presented an effective model of payments that bypassed banks completely for most customers. Tech firms could also challenge banks in the aggregation and analysis of data, which some participants argued was likely to be the most profitable piece of a disaggregated system. While it appeared unlikely that every function currently carried out by banks and exchanges would shift to new tech-driven entrants, a number of participants questioned whether there would be attractive margins in the functions that were left to banks. They argued that banks could simply become low-margin utilities, while productivity gains were achieved by the new entrants. The question of where economic rents would accrue—or as some participants put it, "Who owns the customer?"—would likely determine the shape of the sector.

Not all participants accepted the idea that new entrants would take away the business of banks. While platforms such as PayPal and Facebook already allowed money transfers, these participants argued that they would be hesitant to step too far into banking services, for fear of being regulated as banks. Thus, they saw regulation as creating a natural barrier to full disruption. Even if new entrants had the ambition of competing with banks to provide comprehensive banking services or alternative payments services, they would likely face banking regulations sooner or later. It was argued that new entrants would be unwilling to take on the compliance burden—and even if they tried to do so, incumbent banks would have the advantage due to their superior experience and existing systems.

Finally, a number of participants noted that, regardless of the final shape of the market for banking services, banks and fintech firms of all sorts would not just compete but would also face common challenges. A major challenge was data security, which required constant vigilance and investment, even if (as some participants predicted) existing ledger systems could be made cheaper and more robust replaced with open ledgers in the form of blockchains.

Data localization was another of these technological challenges. Global banks faced expectations from both home and host regulators about what types of data they could collect and store, and where they could do it. Banks themselves would prefer to centralize much of their business data—and for U.S. and European banks, they might be required to bring home data relevant to KYC and anti-money laundering rules—but host country rules often sought to prevent that, whether for reasons of privacy or data security.

What Will Large Banks Look Like?

Circling back to the question of what large global banks would look like going forward, participants focused on the questions of which functions would justify scale and scope, and the distinction between large and global. Overall, they expected that there would be a growing variety of forms among the large global banks, as opposed to the pre-crisis tendency to converge toward multinational universal banking as a business model.

The provision of global services was a central issue for participants. They agreed that multinational corporations would continue to require cross-border financial services, some of which —particularly payments and custody—could best be delivered by sophisticated international banks. But they saw few incentives to be truly global. Rather, many expected that banks would choose a limited set of countries or regions in which they would be directly active, and either rely on correspondent relationships to cover other countries or simply cede that business to other players. This suggested a variety of geographical strategies for banks whose aspirations were to be international rather than global. It would also likely reduce competition for cross-border banking services, which could offer benefits to those banks that continued to service particular types or geographies of service, but could also raise costs for clients. In particular, a number of participants argued that correspondent banking relationships in emerging economies would be reduced as international banks scaled back their global aspirations.

The issue of size was also discussed at length—how large would banks be? Here too, participants predicted a variety of strategies based on comparative advantage and home regulation. In general, participants did not predict new waves of consolidation to create new SIFIs in Europe and the U.S., given the capital and regulatory costs associated with that status. Also, European regulators outside of the Single Resolution Mechanism would likely seek to constrain the absolute size their home banks, to prevent them from becoming too big to fail (or bail). U.S. and Eurozone banks would not be constrained to the same extent, and at least a few would likely follow a global strategy. (While much of the discussion focused on U.S. and European banks, some participants pointed out that major Chinese banks were likely to grow even larger than they already were, but with limited business lines and limited global reach.)

Participants also predicted variety of scope. Some banks would find it useful to follow the universal model, at least in major markets, in order to service the complex needs of their global clients. Such complexity would be an unavoidable outcome of providing comprehensive services. But many would choose simpler, more streamlined business models that would reduce complexity and costs of regulatory compliance. Incumbent custodian banks, for example, might have little incentive to broaden their business models.

All in all, many participants anticipated that the future of large global banks would be smaller, less complex, and less global.

Economic Implications

Finally, participants turned to the implications of these developments for financial systems and for the real economy.

There was considerable discussion of regulators' incentives and actions. One point that was made very clearly was that post-crisis banking regulations had been designed with the goal of preventing future crises and the use of taxpayer money for bailouts in the event a crisis were to arise. The key values were safety and stability rather than innovation, efficiency, or profitability, as seen not only in the G20 agenda of stricter capital and liquidity standards but also attempts to shield insured deposits from riskier activities as exemplified by the Volcker and Vickers rules. Concern over the enforceability of international cooperation, meanwhile, encouraged ring-fencing by regulators who did not want to be stuck using their taxpayers' money to bail out foreigners. And the heightened concerns over market manipulation and KYC were seen as making banking regulation and supervision more punitive than in the pre-crisis period.

While most participants agreed that the combination of new rules and restrictions made individual banks—particularly large banks—less vulnerable to crisis or bad choices, many also expressed skepticism as to whether safer banks meant a safer system. One concern was that fewer banks would be involved in cross-border transactions, making the system less efficient, more expensive, and more vulnerable to the actions of a given player. Higher costs or fewer banks would also tend to shift more financial activity to the shadow banking system, where risk would be harder to gauge and KYC would be more difficult to enforce. A number of participants argued that the attempt to make banks completely safe from the point of view of bailouts would also contradict goals of financial inclusion. Globally, the decline of cross-border players in emerging markets was seen by some participants as a big step backwards. Domestic financial inclusion goals were also seen to be eroded by capital rules and stress tests that made it difficult for banks to lend to borrowers with less than perfect credit. Some participants shared data that demonstrated that this was already well underway in the U.S.

Finally, a number of participants expressed doubt that the post-crisis agenda would actually prevent the next banking crisis. Using the analogy of the Maginot line, some asked whether regulators and bankers had built an impregnable defense against an attack that was not going to happen rather than figure out where the next crisis might arise. In this regard, a number of participants predicted that the next crisis might well originate in a cyber attack or IT systems failure rather than as a classic financial crisis based on miscalculation of risk.

Session 2: Divergence between U.S. and EU Regulations

Session 2 delved further into areas in which divergence between U.S. and EU regulations were creating problems for financial institutions seeking to work on both sides of the Atlantic. Much of that discussion focused on central clearing. Participants also discussed at length mechanisms for reducing, or at least managing, regulatory divergence between the U.S. and EU.

Diverging Regulations

Participants noted a variety of regulatory differences between the U.S. and EU, despite efforts at the G20 and other venues to coordinate global financial policy frameworks. Among the issues discussed were Basel III's capital and leverage rules, central clearing and exchange trading of derivatives, and accounting standards.

They considered several possible explanations for differing implementation of global standards. Many agreed that policymakers sought to adapt global standards to local conditions, which often varied. For example, participants observed that European economies were much more dependent on banks than the U.S. Thus, some argued, EU regulators were wary of applying risk weighting or leverage ratios in a way that would hamper the ability of banks to extend credit. Some participants also pointed to what they saw as differing assumptions about the role of the state, with European policymakers much more concerned about ensuring stability and more willing to intervene in the economy and to apply the precautionary principle relatively aggressively.

A related question was why different jurisdictions adopted new rules at different speeds, as in many cases the U.S. had moved through its post-crisis agenda more quickly than the EU. One common explanation focused on legislative style and regulatory discretion. U.S. legislation tended to grant considerable discretion to regulatory agencies not only to implement rules but also to write them based on principles in the legislation. In contrast, participants saw EU legislation as much more prescriptive and deliberative. Both the granularity of legislation and the difficulty in creating agreement at multiple levels and with multiple national governments contributed to slower introduction of new rules in the EU. Some participants saw the results in the EU as more democratic and more likely to take account of cost-benefit analysis; however, it was also observed that the lack of discretion and the difficulty of changing legislation would inevitably make post-passage international coordination difficult.

While some participants felt that the differing time frames simply reflected the greater complexity of the EU policymaking process, there was also a discussion of whether regulatory reforms offered first-mover or late-mover advantage. They addressed two separate issues. One was whether the speedier introduction of regulations by the U.S. gave it an advantage in terms of setting the agenda for other governments. Although some participants felt that this may have been the intention (or alternatively that U.S. policymakers simply did not take other jurisdictions into account), many pointed out that it had not had the effect of forcing the EU to follow the U.S. approach. Thus, it was not clear that there was an advantage in terms of transatlantic regulatory agenda-setting.

The other issue was whether banks based in a particular jurisdiction benefited from being forced to adopt the Basel III standards earlier or later. While some participants raised the possibility that EU policymakers had intentionally delayed implementation of capital standards in order to give their banks an advantage, a number of participants argued that this actually had negative effects. They pointed that many of the banks that had implemented the new capital standards earlier were in better competitive position than those that had delayed.

The issue of accounting standards also came up in some discussions. Although accounting standards *per se* were not discussed at length, it was noted that differing definitions and rules concerning capital, assets, and loss accounting meant that even identical rules to implement capital and leverage standards could have differential effects in the EU and U.S.

Central Clearing of Derivatives

Most of the discussion of regulatory differences focused on central clearing and exchange trading of derivatives. This was one of the biggest regulatory and market changes in the G20 post-crisis agenda, and was meant to address the problem of counterparty risk that was made apparent in the failure of AIG. However, the effort to create more transparency and less risk in the derivatives markets had ended up creating significant potential barriers to transatlantic markets. The resulting fragmentation was seen by many participants as reducing the efficiency and safety of those markets.

For many participants, the fundamental problem was the necessity for U.S. CCPs to be recognized by EU as fulfilling EMIR clearing requirements; without EU recognition as a qualified CCP, EU-based clearing members—in particular, banks—would not be able to use US clearinghouses, largely due to capital rules. However, the EU and U.S. had developed differing rules on clearing, reporting, margining, making it difficult for U.S. CCPs to qualify for EU equivalence recognition. Thus, without provision for an equivalence determination or an agreement on substituted compliance, the effect would be separate derivatives markets in the EU and U.S., with negative effects on liquidity and costs, and by extension the ability of financial institutions and end-users to hedge their risk. The EU was also mindful of the fact that the U.S. had failed to grant EU clearinghouses substituted compliance, thus forcing EU clearinghouses to register in the U.S. and to apply U.S. rules to their U.S. participants. The EU sought an end to this by conditioning any equivalence determination on their part with a reciprocal substituted compliance determination on the part of the CFTC.

For this reason, participants enthusiastically welcomed the recent news that EU and U.S. regulators had agreed to reciprocal equivalence and substituted compliance determinations, allowing CCPs to engage in transatlantic transactions under one set of host country rules. Still, they expressed frustration that the issue had taken so long to resolve. One reason was seen as the complexity of the task of fact-finding, given the very different sets of definitions and rules. Many participants related this to the lack of coordination in the original deliberations on regulation, including the fact that the U.S. had moved much more quickly and unilaterally in passing the Dodd-Frank Act. It was also argued that, even if policymakers had made earlier efforts to coordinate, differences in legal systems and agency structure would have prevented full convergence.

CCP Resolution and Recovery

While participants showed considerable relief that the new agreement would prevent EU and U.S. markets from being separated in practical terms, many participants felt that it had in fact been the easy part (despite the long and sometimes arduous consultations needed to arrive at the agreement). They argued that coordinating efforts on resolution and recovery would be a much bigger challenge. At the same time, many participants made the case that an effective cross-border resolution regime would be essential going forward, given the concentration of risk in CCPs that had been created by the G20 mandate to require central clearing for most derivatives and to broaden access to all players in the market.

The challenge of CCP resolution and recovery was seen to be substantial, for two reasons. First, the mandate that market players clear derivatives through CCPs meant those players could be exposed to losses if the CCPs failed. Further, the separation of ownership of CCPs from members—CCPs were now owned by firms like ICE—raised the issue of what level of support owners had to give a CCP before calling on capital infusions from members. Second, there were concerns about the implications of relying on foreign members for support. Potential losses for members could trigger prudential concerns on the part of their home supervisor, particularly if the member was a bank that was already under stress. A number of participants questioned whether it would be possible for the CCP's regulator to force the foreign member to contribute to resolution and recovery, which could effectively leave only domestic members footing the bill.

Not all participants were convinced that resolution was a dire problem, however. They pointed out that there was no history of CCPs failing, that margining and paid-in capital were likely to be sufficient to address the failure of even major counterparties, and that CCP members were typically among the most stable financial institutions. They recommended that, rather than focusing their efforts on resolution, regulators instead focus on ensuring effective internal risk management. It was also suggested that the biggest threats to CCP solvency might come from non-traditional sources, particularly IT failure or cybercrime, and that CCPs and regulators ought to focus their attention on those threats.

Reconciling Differences

In addition to discussing differences between EU and U.S. regulation, participants discussed at length how those differences ought generally to be reconciled, in order to prevent the division of the world's two largest financial markets.

While participants did not see harmonization as feasible, given the very different financial systems, legal regimes, and politics both between and within the EU and U.S., many expressed a wish that policymakers and regulators would work to promote a greater degree of convergence. To maximize the potential for convergence, they agreed that cooperation should start at the earliest stages of policymaking, so that principles could be coordinated and major differences in requirements might be avoided. However, participants were not sanguine about the prospect of getting political leaders to take their foreign counterparts' preferences into account in designing policies. They noted that the difficulty of forging domestic (or in the case of the EU, regional) consensus was difficult in itself, and political systems offered little or no reward for accommodating foreigners.

Thus, in most cases, differences would need to be reconciled rather than prevented. Participants agreed that one practical way of addressing many differences was through equivalence or substituted compliance. Many saw this as having considerable potential, as the quality of EU and U.S. regulation and supervision were seen as generally similar. It was suggested that regulators in the two jurisdictions should begin attempts to reconcile differing regulations with the presumption of equivalence and then try to identify key differences that might need to be negotiated, rather than start from the presumption of non-equivalence.

Some participants raised the possibility of including financial services in TTIP negotiations; however, there were mixed opinions on this. A number of participants were wary of embedding financial regulations in a trade agreement, as they worried that it would prevent regulators from responding flexibly to changing conditions, and perhaps even make prudential supervisory actions subject to international arbitration. Others countered that a financial services chapter was unlikely to be prescriptive in nature; rather, they felt that it would focus on national treatment of financial institutions and on creating a dispute resolution mechanism that could facilitate equivalence and substituted compliance. In any event, however, participants did not see TTIP as a near-term solution to coordination problems, given the time it would take to complete negotiations, ratify, and implement. Moreover, the U.S. Treasury had been implacable in its opposition to including financial regulation in a trade treaty that would force ceding authority to trade officials.

A number of participants argued that differences in market regulation were relatively easy to manage through substituted compliance, at least in principle. However, they saw prudential supervision as a much more difficult problem. The reason, as already noted with regard to CCPs, was that taxpayer money was on the line. Many participants expressed skepticism that cross-border resolutions could be managed smoothly, or that they would necessarily comply with any prior agreements when real costs were at stake. Although prior agreements and consultation among colleges of regulators were seen as positive developments, in the event of a big cross-border failure of a major bank or CCP, they worried that prudential regulators and politicians would not see such prior agreements as binding. This helped to explain both efforts to reduce the likelihood of bank failures via higher capital and liquidity requirements, resolution and recovery plans, and enhanced regulation measures such as stress testing, and ring-fencing measures.

Pessimism about the prospect of costly cooperation was compounded by what participants saw as a populist moment in both the U.S. and Europe. Debates over the Greek debt crisis, Brexit, and the Single Resolution Mechanism, in the EU, as well as electoral politics in the U.S., were cited as evidence that concerns over inequality, fairness, and foreign influence were running high. This not only complicated coordination through legislative channels, but also was seen as making regulators wary of using their discretion, lest they be blamed for failures. However, some participants saw glimmers of hope in debates in Europe that focused on addressing the need for credit in the real economy, and not just resentment of banks.

Building Trust

Despite the difficulty of cross-border cooperation, participants saw considerable benefit in efforts to build trust and communication among regulators—both between the EU and U.S., and with other countries. It was argued that building trust required multi-level efforts, involving national leaders; heads of ministries, central banks, and Commission directorates; working level officials; and public outreach.

The U.S.-EU Financial Markets Regulatory Dialogue (FMRD) was seen as one such mechanism for trust-building and coordination. Although some participants observed that early discussions of the FMRD had been frustrating, and often consisted of simply stating existing positions, over time discussions had become more substantive and fruitful. In the case of the CCP equivalence agreement, for example, it had taken considerable time simply to determine what the legal differences were and what impact they might have. Some participants argued that, over time, the process of dialogue had helped to develop both personal trust and institutional trust; however, it was also noted that trust could still be eroded by events or particular personalities.

Some participants observed that some international forums had been particularly successful in creating cooperation, and asked whether they might be models for broader regulatory coordination efforts. For example, the FSB and Basel Committee were noted as especially effective, whereas IOSCO had fewer evident successes. However, there was no clear consensus as to the reasons for success—and therefore the lessons for transatlantic cooperation. Some participants focused on the role of national leaders, pointing out that the FSB received its mandate directly from the G20. Others pointed to the nature of the actors, suggesting that central bankers tended to have more autonomy and power at home, as well as a shared worldview; in contrast, the heterogeneity and politically constrained nature of securities regulators (who tended to have less autonomy than central banks) reduced the scope for IOSCO to be effective. Finally, some pointed to the nature of their respective tasks. For example, there was much greater agreement on the causes and consequences of bank failure than on appropriate standards of conduct for very different financial markets.

Session 3: Liquidity in the Private Fixed Income Market

In Session 3, participants discussed liquidity in the private fixed income market. They addressed differing ways of conceptualizing and measuring liquidity, how liquidity conditions had changed since the period before the global financial crisis, and whether regulatory frameworks were adequate to managing the risk of liquidity freezes at times of stress.

Measuring Market Liquidity

Despite the widespread perception that liquidity in private fixed income markets had declined precipitously since the crisis, several participants questioned whether that common wisdom regarding shifts was accurate. They discussed the usefulness of various measures of bond market liquidity, including turnover ratios, bid-ask spreads, and dealer inventory.

Several participants cautioned against overreliance on turnover rates as a proxy for liquidity. They noted that corporate bond issuance had reached historic heights, and if issuance grew faster than turnover, the turnover ratio would drop. Bond funds and ETFs had also grown in importance, but since ETFs were traded on exchanges, their trading activities did not appear in standard liquidity data. It was also noted that broker-dealer inventory had declined, but not necessarily when controlling for inventories of like-for-like products. All in all, it was argued, it was by no means clear that there was a liquidity issue at all.

It was also suggested that what IOSCO termed "phantom liquidity" had been reduced since the financial crisis. In general, this term was used to refer to strategic order cancellation by high-frequency traders. Some participants argued that much of the apparent decline in liquidity (e.g., in terms of dealer inventory) was actually due to the reduction of phantom liquidity, suggesting that in some countries actual liquidity was higher and possibly denoting increased financial stability. However, this too was hard to track, even for specific classes of bonds, due to patchy data.

Still, many participants remained concerned about market liquidity. One such concern was over the availability of funding. Some participants suggested that smaller asset managers were likely to be disadvantaged in their ability to borrow in order to ride out liquidity squeezes, as banks were limited in their ability to lend by Basel rules and might tend to allocate credit to their bigger clients. Meanwhile, a number of participants felt that the issue of emergency funding had not been adequately addressed by stability regulators. Also, some participants raised the possibility that liquidity might somehow be more "fragile," or vulnerable to rapid freeze-ups, although there was no consensus on how that could be measured.

New entrants

One of the factors cited by participants as driving shifts in market liquidity was the profusion of new entrants. This included a variety of types of bond funds, with varying time horizons, risk profiles, and goals. In many cases, it was argued, the investment of some of these bond funds (for example, target-date funds) was not procyclical, and might even be countercyclical.

Retail bond funds and UCITS were not the only new entrants, as hedge funds and other investors had entered fixed income markets. In the past, major banks and insurers had tended to dominate fixed income markets, effectively constraining opportunities for other entities to trade. But this had changed considerably, for several reasons. Previously, there were high barriers to entry and low barriers to exit; thus, the withdrawal of some major market makers and intermediators had initially reduced the number of players. However, the Dodd-Frank Act created opportunities for new entrants. First, the shift to more trading on CCPs allowed for better execution for investors that had not been players in the OTC markets. Also, Dodd-Frank had made it easier to become a CCP member. At least some of those new entrants had chosen to act as market makers and to provide liquidity when other investors were feeling squeezed. However, European markets were not yet as open to new entrants, and it was argued by a number of participants that they were less liquid as well.

Managing Liquidity Risk

Several participants stressed that market liquidity should not be confused with the risks to individual funds or systemic risk. They noted that, even as markets were constantly evolving, so were approaches to asset management, including how to build portfolio, trade, and monitor and manage risk. In this regard, they argued that it was essential to address fund redemption risk and internal liquidity management.

Redemption risk was seen as being defined not only by investor decisions, but also partly by asset managers' internal liquidity management—making sure they could fund the demand for redemptions. This had become an issue of concern for IOSCO as well, which was trying to understand the interactions between corporate bond market liquidity and stress testing—would increased liquidity in funds mean less liquidity in the corporate bond market in which the funds invest? They observed that rise of interest rates did not necessarily lead to a flood of redemptions. The response of funds depended on internal liquidity management, as well as on the means to slow redemptions, such as redemption fees, suspensions, and redemptions in kind.

Participants also discussed the issue of whether and how liquidity issues translated into systemic risk. It was noted that, even if liquidity might be lower or emergency funding more limited than before the crisis, there was also lower leverage. Combined with the expanded venues for trading and players in the market, some participants argued that there was little danger of a systemic liquidity freeze or of contagion due to forced unwinding of positions.

Discussion of systemic risk also raised the issue of the role of market and prudential regulators. A general conclusion was that liquidity conditions called for an expansive toolkit for managers. A key element was emergency liquidity tools, including suspensions of redemption, redemption in kind, and “gates” or “side pockets.” This raised concern that liquidity risk had been shifted to retail investors. Several participants called for clearer legal bases for such measures as well as more standardized regulator guidance, particularly in EU law. To prevent the need for such emergency measures, it was also suggested that securities regulators should make good use of stress testing and should raise the bar for internal liquidity management for the whole industry.

Session 4: Reform of Secondary Market Structure for Equities

In Session 4, participants discussed secondary market structure for equities, with a primary focus on the US. Major topics included high-frequency trading, fragmentation, and best execution.

High-Frequency Trading

Participants began by discussing high-frequency trading (HFT). Although they agreed that HFT was an important phenomenon in contemporary financial markets, it was noted that there was no commonly-accepted definition of it. One participant argued that, rather than defining HFT on the basis of arbitrary specification of trading speed, it was more fruitful to see it as a collection of traits. High-frequency traders tended to trade on their own account, using a fully automated investment process (albeit with human oversight). They tended to be latency sensitive, directionally neutral, and to focus on intra-day trading while avoiding large overnight positions.

Discussion of the effects of HFT centered on the extent to which HFT increased trading liquidity and the effects on other market participants. It was noted that HFT tended to improve liquidity and reduce bid-ask spreads, reducing transaction costs particularly for retail investors. However, concerns were also raised that algorithmic strategies implemented by HFT created tremendous noise in system as the ratio of orders filled to orders placed decreased, raising brokers' costs of managing information. Also, it was noted that the effects of HFT on liquidity were not uniform across stocks.

One possible way to address that cost was by limiting the ratio of canceled orders to transactions, as the EU had done under MiFID. There appeared to be limited support for such a rule. Although some participants felt that it made sense in principle, they argued that in practice it would just push HFTs to higher-volume stocks, and away from smaller firms, smaller trading venues, and ETFs. One possible compromise that was raised was a charge on excessive cancellations, perhaps limited only to the most heavily traded products..

Another question with regard to liquidity was whether HFTs would step in to provide liquidity in crisis situations, or just increase liquidity during normal times. It was argued that market volatility tended to reward liquidity providers, so that in general HFTs would want to step in when markets were under stress. They also cited evidence that HFTs stepped in when trading volumes dropped; however, they were not obligated to do so. And no trader would be likely to step into a collapsing market where there was no clear price on offer. But this was true before HFT was invented, classically demonstrated in the 1987 market break when many NYSE specialists ignored their duty to support a falling market.

Participants also raised the question of whether exchanges should be allowed to institute speed bumps. They noted that IEX had included a speed bump at 350 microseconds in its application to the SEC to set up an exchange. One concern was that the speed bump might constitute a selective delay, which the exchange could override for its own benefit. A more fundamental concern was over process—rather than being subjected to the SEC's whole-market assessment of costs and benefits as would be required under a new regulation, IEX was attempting to effectively make a major rule change through an exchange application with an interpretive rule attached.

Fragmentation

Participants also discussed the issue of fragmentation of markets and trading venues. They noted that, in the past, there had often been arguments in favor of consolidation, and a central limit-offer book was considered ideal. However, participants expressed the opinion that, in general, having diverse markets benefited investors. Having moved away from pit trading to electronic trading, investors no long saw a particular economies of scale. Diversity of markets offered resilience if one venue were to suffer a slowdown or halt. Moreover, competition among markets had contributed to increased speed and quality of execution, reduced transaction costs, and fewer opportunities for abuses such as front-running.

There was some concern over dark pools. While participants had no objection to dark pools in principle or to the fact that some market participants preferred to trade in the dark, there were concerns expressed over the lack of transparency with regard to the rules for trading on particular dark pools and whether such rules were being applied fairly to participants. Participants generally agreed that there should be more disclosure (although some participants expressed hesitation over proposed SEC rules mandating pre-filing reviews, out of concern that they might slow innovation). One question was where the line should be drawn between dark pools and the "lit market." EU rules on non-exchange trading venues mandated pre-trade quote transparency rules for trading in a security above a threshold of 4%, whereas the cut-off in the U.S. was 5%.

Best Execution

The final focus of discussion in Session 4 was over best execution. In the US, regulation required that any venue receiving an offer must execute it at least at the national best price (NBBO, or national best bid or offer) or send it to the venue with the NBBO. However, several questions were raised about this rule. For example, should investors be allowed to sacrifice best price in exchange for speed, market depth, or trading reliability? The practice of "payment for order flow" was also seen as potentially problematic, as it could create a conflict between a broker and investors. However, it was argued that the potential benefit to the broker was not very large, and that measures (including better disclosure) could be put in place to mitigate any conflicts of interest.

Despite competition among exchanges and other trading venues, some participants pointed out that there was no competition at all in terms of market data. They argued that in the US, exchanges effectively formed a cartel that controlled market data. Broker-dealers were required to provide trading info for free, then pay to receive consolidated tape information supplied by exchanges. Even when individual exchanges were making additional money by selling their individual proprietary feeds (which supply faster information), broker-dealers were still obligated by law to buy the consolidated tape, raising costs for them. One way to address the issue would be through better regulation of the price of data supplied through the consolidated tape. Alternatively, one could allow competition in consolidating proprietary feeds in lieu of having exchanges provide a consolidated tape.

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

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