

2010 Europe-U.S. Symposium

Agenda

THURSDAY, MARCH 18

6:30–6:40 p.m.

GREETINGS

- Hal Scott, Nomura Professor and Director, Program on International Financial Systems (PIFS), Harvard Law School
- Staffan Jerneck, Director and Director of Corporate Relations, Centre for European Policy Studies (CEPS)

6:40–7:10 p.m.

KEYNOTE ADDRESS

- Dan Tarullo, Governor, U.S. Federal Reserve Board

7:15–9:00 p.m.

DINNER AND KEYNOTE ADDRESS

- Lew Kaden, Vice Chairman, Citi

FRIDAY, MARCH 19

8:15–8:25 a.m.

WELCOME AND OPENING REMARKS

- 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 (CEPS)

8:25–8:45 a.m.

PANEL SESSION

Topic 1: Managing Risk Post-Financial Crisis

- Panelist: Andy Kuritzkes, Partner of Public Policy, Oliver Wyman
- Panelist: Chris Bates, Partner, Clifford Chance LLP

8:50–10:15 a.m.

SMALL GROUP SESSIONS

Group

- 1 *Facilitator:* Andy Kuritzkes, Partner of Public Policy, Oliver Wyman
Facilitator: Penelope Naas, Managing Director, European Government Affairs, Citi
Reporter: Eric Morgan de Rivery, Partner, Jones Day
- 2 *Facilitator:* Dagmar Linder, Managing Director, Deutsche Bank AG
Facilitator: Cristiano Zazzara, Global Head of Banking Business, Riskmetrics Group
Reporter: Brandon Becker, Executive Vice President and Chief Legal Officer, TIAA-CREF
- 3 *Facilitator:* Peter Axilrod, Managing Director, The Depository Trust & Clearing Corporation (DTCC)
Facilitator: Michel Maquil, President and Chief Executive Officer, Luxembourg Stock Exchange
Reporter: Piero Cinquegrana, Research Fellow, Centre for European Policy Studies (CEPS)
- 4 *Facilitator:* Klaus Durrer, Global Head, Legal and Compliance Control Framework, UBS
Facilitator: Dick McCormack, Executive Vice Chairman, Bank of America Merrill Lynch
Reporter: Simon Gleeson, Partner, Clifford Chance LLP
- 5 *Facilitator:* Staffan Jerneck, Director and Director of Corporate Relations, Centre for European Policy Studies (CEPS)
Facilitator: Bob Pickel, Executive Vice Chairman, International Swaps and Derivatives Association (ISDA)
Reporter: Alastair Sutton, Partner, White & Case LLP
- 6 *Facilitator:* John Houston, Senior Partner, Kreab Gavin Anderson
Facilitator: Klaus Willerslev-Olsen, Deputy Chief Executive, Danish Bankers Association
Reporter: Nick Reinhardt, Senior Policy Advisor, Fleishman-Hillard

10:25–10:45 a.m.

PANEL SESSION

Topic 2: Implications of Capital Markets Reforms on Both Sides of the Atlantic

- Panelist: Eddy Wymeersch, Chairman, The Committee of European Securities Regulators (CESR)
- Panelist: Kenneth Bentsen, Jr., Executive Vice President for Public Policy and Advocacy, Securities Industry & Financial Markets Association (SIFMA)

Group

- 1 *Facilitator:* Kenneth Dam, Max Pam Professor Emeritus of American and Foreign Law and Senior Lecturer, University of Chicago Law School
Facilitator: Peter Tils, Chief Executive Officer, Central and Eastern Europe, Deutsche Bank AG
Reporter: Brandon Becker, Executive Vice President and Chief Legal Officer, TIAA-CREF
- 2 *Facilitator:* Nick Collier, Head of EMEA Government Relations, Morgan Stanley
Facilitator: Dominique Graber, Head of European Public Affairs, BNP Paribas
Reporter: Simon Gleeson, Partner, Clifford Chance LLP
- 3 *Facilitator:* Christine Farnish, Managing Director, Public Policy, Barclays
Facilitator: Alan Houmann, Managing Director, European Government Affairs, Citi
Reporter: Alastair Sutton, Partner, White & Case LLP
- 4 *Facilitator:* Jerry Hawke, Partner, Arnold & Porter LLP
Facilitator: Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies (CEPS)
Reporter: Nick Reinhardt, Senior Policy Advisor, Fleishman-Hillard
- 5 *Facilitator:* Mitchell Coen, Director, Government Relations, Barclays
Facilitator: Mark Slaughter, Chief Administrative Officer, Investcorp International
Reporter: Eric Morgan de Rivery, Partner, Jones Day
- 6 *Facilitator:* Michael Dawson, Managing Director, Promontory Financial Group
Facilitator: Guido Ferrarini, Professor of Business Law, University of Genoa; Fellow, European Corporate Governance Institute, Brussels
Reporter: Piero Cinquegrana, Research Fellow, Centre for European Policy Studies (CEPS)

12:20–1:25 p.m. **LUNCH AND KEYNOTE ADDRESS**

- Martin Merlin, Head of Unit G1, Financial Services Policy, Directorate General for the Internal Market and Services, European Commission

1:30–3:00 p.m. **PANEL SESSION AND PLENARY DISCUSSION**

Topic 3: Crisis Resolution Procedures: Are We Ready for the Next Crisis?

- *Panelist:* Wilson Ervin, Senior Advisor to the Chief Executive Officer, Credit Suisse
- *Panelist:* Thomas Huertas, Director, Banking Sector, The Financial Services Authority
- *Panelist:* Gary Parr, Vice Chairman, Lazard
- *Panelist:* Dirk Schoenmaker, Dean, Duisenberg School of Finance
- *Moderator:* Hal S. Scott, Nomura Professor and Director, Program on International Financial Systems (PIFS), Harvard Law School

3:00–6:00 p.m. **REPORTERS MEETING**

6:45–7:30 p.m. **DINNER AND KEYNOTE ADDRESS**

- Malcolm Knight, Vice Chairman, Deutsche Bank

SATURDAY, MARCH 20

8:15–9:15 a.m. **PRESENTATION AND DISCUSSION**

Topic 1: Managing Risk Post-Financial Crisis

- *Chair:* Tara Skinner, Solution Architect, SAS Americas Risk Practice
- *Chair:* Nick Reinhardt, Senior Policy Advisor, Fleishman-Hillard

9:15–10:15 a.m. **PRESENTATION AND DISCUSSION**

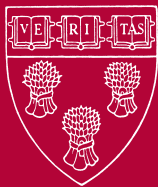
Topic 2: Implications of Capital Markets Reforms on Both Sides of the Atlantic

- *Chair:* Stefan Gavell, Executive Vice President, State Street Corporation
- *Chair:* Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies (CEPS)

10:30–11:30 a.m. **PRESENTATION AND DISCUSSION**

Cross-Atlantic Implications of the Greek Crisis

- *Chair:* Arnaud de Bresson, Managing Director, Paris Europlace
- *Chair:* Kenneth Dam, Max Pam Professor Emeritus of American and Foreign Law and Senior Lecturer, University of Chicago Law School
- *Moderator:* Brandon Becker, Executive Vice President and Chief Legal Officer, TIAA-CREF



Harvard Law School Program on International Financial Systems
Centre for European Policy Studies

Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States

Armonk, New York • March 18–20, 2010

Final Report



Founded in 1986, the Harvard Law School Program on International Financial Systems (PIFS) fosters the exchange of ideas on capital markets, financial regulation, and international financial systems through its acclaimed portfolio of *Symposia on Building the Financial System of the 21st Century*. PIFS also conducts research and organizes special events on these topics.

Each year, PIFS bilateral Symposia bring together senior financial leaders, high-ranking government officials, and distinguished academics from the United States and their counterparts from China, Europe, Japan, and Latin America for intensive dialogue on issues affecting international capital markets.

Off-the-record and closed to the media, the invitation-only PIFS Symposia convene leading market practitioners at off-site retreat venues. The Symposia model features candid, intimate exchanges between global counterparts within small-group discussions. Keynote addresses and panel sessions serve to initiate and enhance the interactive, small-group dialogue, which is conducted under Chatham House Rules in order to foster an open exchange of ideas. These discussions are synthesized and presented on the final day of the Symposium in a plenary session, and then summarized and published in the following Symposium Final Report.

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HARVARD LAW SCHOOL
PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS

2010 Symposium on Building the Financial System of
the 21st Century: An Agenda for Europe and the United States

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To access Symposium concept papers, please visit

www.law.harvard.edu/programs/about/pifs/symposia/europe/index.html

and click on Briefing Materials.

Symposium Final Report

The eighth annual Europe-U.S. Symposium was held in Armonk, New York March 18-20, 2010. In the background, the world economy was showing signs of improvement, and Symposium participants expressed a mood of cautious optimism for continued recovery in the wake of the financial crisis. At this same time, Brussels and Washington each had reform efforts underway, and participants assessed the potential outcomes and effects of the legislation being considered on both sides of the Atlantic, while also expressing a hope for closer European-American coordination.

Against this backdrop, participants took up three central issues:

- Managing Risk Post-Financial Crisis
- The Implications of Capital Markets Reforms on Both Sides of the Atlantic
- Crisis Resolution Procedures: Are We Ready for the Next Crisis?

Finally, a fourth topic was taken up on the final morning of the Symposium to assess the cross-Atlantic implications of the Greek crisis.

Session 1

Managing Risk Post-Financial Crisis

This session highlighted that risk management is currently in a state of flux, as market participants and regulators seek to apply lessons from the crisis. While there was no consensus view on how to best define and effectively manage risk post-crisis, participants agreed that effective risk management starts with a corporate culture that rewards sensible behavior and avoids excessive risk-taking. Moreover, they concurred that granting Credit Risk Officers (CROs) full and unconditional independence and full access to the board would be appropriate. Discussions also converged on the idea that government supervisors should be better trained, better paid, and have more market experience.

DEFINITION OF RISK

Some participants argued that risk is about the possibility of losses, and therefore risk management is ultimately about capital management. They pointed out that business and lending cycles are inherent features of modern economies. In light of the fickle nature of confidence and the maturity mismatches innate in financial systems, booms and busts cannot be prevented, but their effects can be greatly mitigated. Thus, managing risk means primarily having sufficient capital buffers and requesting enough collateral for transactions to withstand periodic downturns or crises, they said.

Other participants held the view that effectively managing risk implies having reliable information about counterparties, whose exposures in today's world change rapidly—sometimes weekly. They felt that global firms often have a poor understanding of counterparty risk, given that the complex linkages across and within institutions can make this picture murky. A few referred to intra-company derivatives as

examples of transactions that exacerbate information problems between counterparties.

A number of participants pointed out that risk and interconnectedness often coincide. They remarked that the more linkages exist, the more likely that credit events become systemically important. Many disagreed, arguing that a global, integrated economy requires an interconnected financial system, and that reducing these linkages would lessen economic integration. The question was raised on whether Europe would adopt a “precautionary principle” in financial services, whereby tolerance of risk would be much lower than in the past, leading to a strangling effect on economic growth.

FIRM'S RISK MANAGEMENT

Participants agreed that tone at the top is essential for firms to successfully manage risk. Many thought that during the 2007-2009 financial

crisis, the key variable that made the difference between the institutions that survived and those that failed was the quality of the management. There was also a consensus that the firms that emerged from the crisis were those whose management had incentivized sensible growth without detriment to the firm's solvency.

Participants also identified a need to reform corporate culture toward the goal of better risk management. During this discussion, significant emphasis was placed on the role of personal and psychological incentives within financial companies and how these factors ultimately played a role in the crisis. Participants highlighted that in the pre-crisis world, the top management of financial institutions often chose to reward unfettered growth and innovation, ignoring the long-term consequences of the risks being taken. Most agreed that in a post-crisis world, management should place less emphasis on innovation and growth and more weight on stability and soundness.

During the course of this discussion, a disparity of views emerged between those who favored quantitative and qualitative approaches to risk management. Some participants noted that, although quantitative models supplied a false sense of confidence in the run up to the crisis, qualitative risk management is no panacea for better managing risk in the future. They noted that, after all, it was the Enron collapse that drove risk management away from judgment calls into the world of risk models. Several questions were posed on the topic of risk: Can we devise heuristics to decide when to rely on risk models and when to trust the common sense of risk managers? Is it possible to integrate quantitative and qualitative risk management? Should supervisors have strong quantitative backgrounds? Participants had no immediate or easy answer to these questions.

STATURE OF CREDIT RISK OFFICERS



One participant compared the role of CROs to the Greek mythological figure of Sisyphus, whose punishment consisted of rolling a

large rock uphill only to see it rolling down when he was close to reaching the top. This metaphor served to illustrate the ungrateful job of spotting risks within firms.

An interesting debate developed around the theme of the appropriate role of CROs. One side contended that CROs should be “detectives,” asking hard questions around the firm's departments and having a broad mandate to uncover risky activities. They argued that CROs should leave the “checkbox” approach behind and embrace qualitative risk management to assess those risks that are unquantifiable. The other side of this debate thought that the role of risk manager as “detective” is better suited for auditors, since CROs would be shut down immediately if they were to run against business imperatives. These participants proposed seeing CROs as partners, a view that seeks to mitigate the general hostility of business managers toward risk managers. It was also noted that Chief Compliance Officers of U.S.-based institutions have a narrow mandate to ensure that the firm complies with regulation, basically the “checklist” approach, whereas Chief Compliance Officers in European firms have much broader mandates, a similar role to Chief Risk Officers in the U.S.

A majority of participants endorsed the view that CROs should enjoy greater independence and resources than in the present state of affairs. Likewise, the majority view emphasized that CROs should have direct access to the board of directors in order to report on risks without intermediation or interference. Also, many agreed that CEOs, CFOs, and CROs should sit at the same table and have discussions among equals. Finally, participants stressed that there should be a greater sense of collegiality within firm management that seeks to promote views challenging the conventional wisdom and encouraging internal debate around risk-related topics. Many, however, doubted that changes in internal governance and culture would be sufficient to prevent a return to excessive risk-taking within firms, agreeing that external as well as internal checks and balances are paramount to reform risk management.

GOVERNMENT SUPERVISION

There was widespread agreement among participants that supervision should be of better quality. Participants felt that supervisory agencies should raise salaries in order to attract talent from the private sector to the regulatory agencies. Moreover, some proposed the establishment of an international institute for regulators that would create global standards. Many thought that prior to the crisis, supervisors had abdicated their role in overseeing firms because of the conviction that firms would police themselves. Other participants disagreed, arguing that supervisors had taken a “bureaucratic” approach to risk management, whereby CROs in many cases had come to serve merely as “nannies” to regulators and sought only to comply with the rules, while at the same time failing to ask hard questions about risk-taking within the firm.

Many participants lamented the fact that most supervisors are civil servants with careers in government, but with little or no direct market experience. They maintained that supervisors should spend a substantial part of their careers in the private sector in order to have a thorough understanding of market realities gained through first-hand experience. There was a concern, however, that revolving doors between government and markets for regulators may have the effect of intensifying the problem of regulatory capture.

The issue of information sharing across regulatory agencies received a great deal of attention during this discussion. Participants agreed that having up-to-date information during crises—when timing is crucial—is of paramount importance. Participants maintained that the most critical pieces of information include: (1) an inventory of legal entities, (2) a map of business lines, (3) sources of funding, and (4) an accounting of hedging across legal structures.

Some also highlighted that during times of distress regulators have been reluctant to reveal weaknesses within their national financial system for political reasons. For instance, if third-country supervisors—after receiving information from a home supervisor—tipped off their national firms about

weak home institutions, this could precipitate the failure of a domestic firm, an event with considerable political fallout.

No agreement emerged on the standards supervisors and risk managers should have in order to do their jobs most effectively. This lack of consensus stemmed from the uncertainty surrounding risk management, the nebulous nature of risk, the indeterminacy of capital, and the lack of convergence on a roadmap for reforming risk management. Participants agreed, however, that substantial effort should be dedicated to rebuilding the foundations of such a critical area.

OPEN QUESTIONS

Several open questions remained from this discussion, which reflected the debate and changing nature of risk management within finance. A majority considered internal and external stress-testing under catastrophic scenario assumptions to be a significant step in the right direction toward preventing future crises. Participants agreed, however, that the problem with stress testing lies in how to devise tests rigorous enough to be meaningful but not so stringent that no firm would survive them.

Another issue was whether risk externalization through trading of financial products enhances or reduces systemic fragilities. One side argued that a responsible use of derivatives serves the useful purpose to make illiquid assets liquid and liberate credit so that the cost of capital is lower. The other side claimed that misusing risk externalization can have large consequences, and the advantages are not as apparent when compared to the significant downside risks.

CONCLUSION

There was widespread agreement that risk management is in need of an in-depth reassessment, since the Global Financial Crisis revealed major weaknesses in governance, risk modeling, and control processes. Conclusions from this discussion

revealed that changes in corporate governance and culture are essential, and that in terms of culture, rewards and incentives should be geared toward a sensible approach to risk with dutiful consideration to the firm's solvency.

In terms of governance, there was consensus that, under a more successful risk management model, CROs should enjoy much greater independence and resources within their firms. It was also agreed that adjusting culture and governance are necessary but not sufficient steps in reforming risk management. For instance, supervision also needs to improve substantially, with officials who are better trained, better paid, and have greater market experience. Going forward, the challenge is to also establish global standards for effective supervisors and risk managers.

Session 2

Implications of Capital Markets Reforms on Both Sides of the Atlantic

This session underlined that whatever reforms may come out of Brussels and Washington during the current legislative processes, the New Normal will be a scenario with less liquidity, less credit, higher risk premia, and greater pressure on banks' balance sheets. Participants presented a moderately bright picture of Trans-Atlantic cooperation on financial reform. There were, however, several elements such as the Volcker Rules, accounting issues, and skeptical public opinion that are complicating factors in achieving greater coordination. Participants agreed that, surprisingly, the EU finds itself ahead of the U.S. in reforming its regulatory framework, and participants expressed concern regarding the process in the U.S. Congress to move forward with financial reform. In regard to derivatives, a majority viewed central clearing as the optimal solution to systemic concerns.

THE NEW NORMAL

Participants agreed that after years of underpricing risk, the New Normal will have less liquidity, less credit, and higher risk premia. There was also consensus that at the moment, market conditions are relatively benign thanks to an abundance of monetary and fiscal support, but that when the state stimuli are withdrawn, liquidity will be less abundant than in the past. Discussants predicted that in the future, financial actors will discriminate more between different counterparties, demanding higher spreads for riskier activities, and that government finances will be under severe strain due to the large burden inherited from bank bailouts and lower growth capacity.

Furthermore, participants expressed the view that

markets are already putting pressure on banks and other financial institutions to become more transparent. They thought that accounting techniques used to disguise risk with off-balance-sheet entities will no longer be acceptable. For instance, Special Purpose Vehicles and Structured Investment Vehicles will be accounted for as liabilities, since distinctions between on- and off-balance-sheet will no longer have any meaning.

THE EU-U.S. DIALOGUE

A few participants argued that the financial crisis of 2007-2009 has put a brake on the EU-U.S. dialogue, citing the fact that regulators are “talking globally but acting locally.” They

suggested that this trend derives from both a generalized lack of trust between governments and also disenchanted public opinion on both sides of the Atlantic. These participants urged regulators to put increased emphasis on the Trans-Atlantic dialogue, setting clear goals and deadlines for the future.

A majority of participants disagreed with this pessimistic reading, however, claiming that, in spite of the many changes taking place in both EU and U.S. regulatory systems, convergence across the Atlantic is happening on several fronts. They argued that the two jurisdictions should not have exactly the same rules, but rather rules and regulatory structures that are approximate to one another. That said, most participants agreed that both the U.S. and Europe should bring talks to the global level, given the growing importance of Asia and in order to avoid regulatory arbitrage. Employing global forums such as the IMF or the G20 should be a priority for policymakers in both Brussels and Washington, they said.

Many found it rather surprising, given the transnational nature of the EU, that Europe is moving more quickly than the U.S. in reforming its financial system. They attributed the U.S. delay in its reform process to the health care reform legislation, which had absorbed the U.S. political system for almost a year. Others mentioned the differing approaches taken as the main cause of the varying pace of reform, whereby the U.S. is aiming toward comprehensive reform while the EU is pursuing an issue-by-issue model. Finally, participants viewed the U.S. Congress as an unpredictable element in financial reform, due to political polarization and also opaque decision-making. Some discussants cited the multiplicity of bills presented (House, Senate, Dodd bill, and the Administration's) as further complicating the landscape.

OTC DERIVATIVES

One discussant sought to put the discussion on derivatives into historical context, citing that OTC derivative markets are fairly young. For instance, it was observed that while equity and bond markets date back at least 300 years, OTC

derivatives are no older than 30 years. Therefore, it was suggested, OTC derivatives markets are in constant evolution, and clearing, standardization, and novation should be seen as steps in this evolutionary process. By extension, it was proposed regulators should make sure—before mandating that standardized contracts be cleared—that clearinghouses are prepared to accommodate these products.

An intense debate developed around the issue of whether forcing OTC derivatives onto an exchange is an appropriate response to the crisis. One side argued that the crisis has shown that products traded on-exchange—equities in particular—have remained liquid (with bid-ask spreads even declining) in the face of a massive decrease in turnover. They also contended that products traded OTC have experienced illiquidity and effectively functioned as conveyor belts for systemic risk. Thus, forcing OTC derivatives on exchange would be beneficial.

The other side retorted that the liquidity of OTC derivatives is not the priority. Rather, regulators should be concerned solely with systemic risk, and central clearing is very likely to solve that problem. They further argued that OTC derivatives serve mainly for hedging purposes—not for trading, price discovery, or investment—hence the illiquidity of the contracts is only natural. This side argued that since clearing of standardized contracts is underway, mutualization of losses ensures that counterparty default does not threaten the world's financial system.

VOLCKER RULES

A majority of participants thought the Volcker Rules proposed by the U.S. Administration is a bad idea, both in process and substance. In regard to process, participants regarded the Volcker Rules as a complete surprise for both market participants and regulators across the Atlantic. Few believed that the various tenets of the Volcker Plan represented just a reaction to populist pressure.

In regard to the substance of the proposal, many participants doubted that a functional restriction of

using insured deposits for proprietary trading was a suitable policy for the financial system of the 21st century. The opposition to the proposed rule had several arguments: (1) it would be damning for international cooperation because the EU would refuse to embrace a contemporary version of the Glass-Steagall Act, given that the long-rooted European tradition of universal banking would not be changed overnight; (2) rather than banning proprietary trading, higher capital charges on the trading book should be applied to discourage excessive trading activity; and (3) a precise definition of “proprietary trading for own account” is elusive, since hedging and discretionary portfolio management considerably overlap with activities that would be banned under the Volcker Rules. For instance, participants noted, the Volcker Rules excludes foreign exchange swaps and forwards from the definition of proprietary trading.

OTHER ISSUES

Participants argued that it makes a good deal of sense to divide trade repositories and clearinghouses by asset class rather than by geography. They recognized, however, that political imperatives might make these entities hard to implement as global institutions. One participant proposed that trade repositories should be spread around the world, with a deterrence mechanism preventing regulators from denying access to data to one another. The number and geography of clearinghouses posed a more difficult question, as domestic regulators are accountable to local audiences and want to oversee large systemic entities within their borders.

Participants were divided on the issue of non-equity markets transparency. They could not settle on whether bond markets—especially in Europe—should enjoy more post-trade transparency. One side argued that the TRACE model (a system adopted in the U.S. where trades completed are disclosed to the market with a 15-minute lag) could be extended to Europe. Proponents of this approach argued that large retail presence in certain European countries (for instance Germany and Italy) justifies this intervention, since bond markets experience consistently higher bid-ask

spreads than equity markets. The other side disagreed, claiming that retail presence is not so evident in European context, and that fixed-income markets are mainly professional in nature.

Accounting surfaced as the critical test for Trans-Atlantic relations during discussions. Some participants took the view that the U.S. should adopt IFRS and drop U.S. GAAP to be in synch with international standards. Advocates for this side observed that differences in accounting standards make international comparisons hard to make, complicating agreement in other areas such as special resolution procedures and capital adequacy. Others argued for an equivalence approach. The European Commission has granted the U.S. GAAP equivalence status, and the U.S. did the same for foreign firms employing IFRS. Some participants, however, feared that equivalence could be used as protectionism in disguise, whereby the EU would use the grant of mutual recognition as a political tool. Others disagreed, claiming that, so far, equivalence has worked well and the Commission had extended its use to other areas such as Credit Rating Agencies.

CONCLUSION

During the discussion of this topic there was consensus that capital markets reform is moving ahead on both sides of the Atlantic. Participants felt that whatever the outcome of the current legislative processes, the New Normal will be a scenario where market conditions will not be as benign as in the past. There was a view that considering the difficult setting, regulators are putting sizeable efforts in coordinating the changes to their regulatory frameworks across the Atlantic to limit regulatory arbitrage and converge on globally accepted standards. There was also a sense, however, that both Europe and the U.S. could and should be doing more to implement the global agenda agreed in the context of the G20. Finally, it was agreed to by participants that some issues—especially the Volcker Rules, accounting, and mutual equivalence—will be a test for the future of the EU-U.S. dialogue.

Session 3

Crisis Resolution Procedures: Are We Ready for the Next Crisis?

This session highlighted that resolution procedures play a critical role in determining risk and that regulators should have improved contingency plans to deal with future crises. Another area of consensus was that both shareholders and unsecured creditors should bear losses when a firm fails in order to contain moral hazard; however, participants could not settle on whether having an explicit list of “Too Big to Fail” institutions is a good idea. Finally, participants set limited expectations on the prospects for special resolution regimes for international financial institutions (IFIs). Most agreed that such regimes are necessary in order to limit the impact of a failing IFI, but few were hopeful that political realities would allow national rules to converge or be sufficiently coordinated.

CRISIS MANAGEMENT

Participants felt that although policymakers on both sides of the Atlantic acted to the best of their abilities during the recent financial crisis, uncertainty in the markets and a haphazard public response exacerbated the costs of the financial turmoil. For instance, one panelist highlighted the chronology of events during 2008, in which the U.S. government took a series of disparate responses toward failing institutions, including: (1) on March 14, 2008, the Fed provided a loan to JPMorgan Chase to acquire Bear Stearns, saving all creditors and preferred except common shareholders; (2) on September 7, 2008, in the case of Fannie Mae, only creditors were rescued, wiping out both preferred and common equity; (3) during the weekend preceding September 15, 2008, the U.S. refused to rescue Lehman Brothers, leaving courts to determine how to sort out the bankruptcy; and (4) two days later, the government saved AIG

shareholders and creditors from the complete losses that would have resulted in bankruptcy.

Participants agreed that governments should devise and test contingency plans on how to operate during the next financial crisis. It was emphasized that just as military planners prepare for the unthinkable, regulators should also have clear operating procedures for dealing with systemic risk, and simulations should be regularly carried out in this realm. Participants emphasized that speed, precision, and the minimization of uncertainty are paramount in order to contain systemic events. For instance, it was pointed out that in the case of Lehman Brothers, disorderly liquidation, in the absence of a clear resolution procedure, functioned as a loss multiplier with underlying asset losses estimated at \$25 billion, becoming six times larger at \$150 billion.

RESOLUTION PROCEDURES AND RISK

There was widespread consensus that resolution procedures determine risk and that, likewise, any explicit government guarantee of creditors has an immediate impact on the risk premium (expected loss) that is demanded by counterparties. *Ceteris paribus*, if markets expect a firm to be bailed out risk premia will be lower, thereby distorting the incentives of the guaranteed firm to engage in more risk-taking. Conversely, if markets foresee no bailout, the firm in question will be at a competitive disadvantage with respect to guaranteed firms.

Participants converged on the fact that the collapse of Lehman Brothers triggered the systemic phase of the financial crisis. There was agreement that the Lehman failure changed the perception in the markets that governments would not allow large institutions to fail. They reflected that immediately following the Lehman collapse, spreads of repos (many of which were not collateralized by Treasuries or cash) over government-guaranteed debt skyrocketed, which indicated that beforehand the crisis repurchase agreements between banks were considered almost risk-free. Participants also agreed that the markets were not differentiating between good and bad creditors. A majority also endorsed the view that shareholders and unsecured creditors should bear losses in case of insolvency.

BAIL-IN AND BAIL-OUT

Some participants proposed to re-privatize moral hazard rather than bailing out institutions or arranging mergers with taxpayer money. This bail-in proposal would force (in the case of a failing institution) a conversion of common shares into warrants, and preferred equity and junior creditors into common equity, while also transforming a part of senior unsecured debt into new equity. In this way, the firm's solvency would be ensured and markets would account for the real risks when dealing with counterparties, rather relying on implicit government guarantee. Thus, it was asserted, the bail-in would re-establish market discipline.

Other participants, however, were not convinced that this could work. In order to implement the bail-in proposal, it was suggested that legislators need to first reform bankruptcy laws and create an authority that can exercise the forced conversion. Participants agreed that this process would need to be speedy, to avoid disruption—similar to the procedure used by the U.S. Federal Deposit Insurance Corporation. Moreover, the point was made that with the bail-in procedure, the cost of capital will become much higher as investors shun the portion of the debt that will be converted into equity when trouble arises. Finally, international cooperation is essential to address intra-company and international linkages during the forced conversion. How to share the losses across countries? Who decides about the firm's insolvency?

LIVING WILLS

There was significant consensus that special resolution procedures, popularly referred to as “living wills,” can provide useful measures to re-institute market discipline and contain moral hazard. Participants saw living wills as having several advantages: they force firms and supervisors to review contingency plans regularly; they provide up-to-date information and maps on business lines, legal entities, funding sources, and hedging (since the firm has to submit yearly plans); they incentivize simpler legal structures; they also salvage those parts of the firm that are systemically important, while letting the other parts go bankrupt; and finally, they provide certainty during times of crisis.

Yet, to be weighed against these advantages, participants also expressed several concerns. For instance, and critically, it was pointed out that there is no assurance that living wills will work in the next crisis, since they have never been tested during times of upheaval and the effort to resolve complex groups is unpredictable. Others pointed out that, rather than promoting simpler corporate structures, living wills will encourage further legal wrangling in order to comply with regulators. Most importantly, living wills could only dictate measures a firm could take to save itself, not how regulators will actually deal with a failing firm.

The crucial question is when bailouts will be necessary in the future, despite all efforts to avoid them. One participant noted that the U.S. government was convinced that the failure of Lehman Brothers would not represent a systemic event since they had a mapping of its derivative exposures. Participants noted that this debate boils down to finding a metric for interconnectedness, but with two different views on the variables that would determine systemic importance. One side thought that size is the most appropriate proxy. The other side retorted that even small players can become systemic in times of uncertainty.

LIQUIDITY AND CAPITAL REQUIREMENTS

Many participants thought that in the future, regulators will focus much more on legal entities rather than holding companies, provided that it is the legal entity and not the group that declares bankruptcy. They also recognized an inevitable tension between legal entities and business lines. For instance, the U.K. Financial Services Authority has adopted a policy of self-sufficiency for legal entities, whereby U.K. branches and subsidiaries cannot rely on the parent company to meet liquidity requirements. Many expressed concern that duplicate buffers may represent a drag on economic growth.

With respect to capital requirements, participants could not settle on whether “Too Big to Fail” institutions should have higher charges. Again, the problem of defining systemically important firms arises. On the one hand, compiling a list of “Too Big to Fail” institutions would encourage moral hazard and distort competition. Moreover, firms off the list may still trigger systemic events during a crisis. Perhaps “constructive ambiguity” would provide more flexibility but, on the other hand, would create more uncertainty.

Participants agreed that capital and liquidity requirements are political and not technical issues and that the G20 and not the Financial Stability Board should be the main forum of discussions, because these decisions are highly consequential for the future prospects

of the global economy. The view was expressed that lower employment and slower economic growth may have arisen as a result of the implementation of Basel I in 1988, for instance, and that this had had a dampening effect on growth at the beginning of the 1990s. Others voiced concerns that the politicization of the issue of capital requirements may serve to raise the stakes and end in acrimony—an outcome much less likely if discussions are kept at the technocratic level.

INTERNATIONAL COOPERATION

Participants agreed that international differences in legal culture and diverging resolution regimes make convergence on an international agreement for special resolution procedures unlikely. The problems of sharing the losses and determining insolvency are probably the main hurdles. Participants recognized that international cooperation is essential to achieve meaningful results, but few were hopeful that political realities would allow national rules to converge sufficiently.

CONCLUSION

Participants thought that if another financial crisis struck tomorrow, the global financial system and its component parts would in fact be completely unprepared. There was agreement that the intellectual terrain has shifted significantly and new ideas and proposals such as living wills, bail-ins, and contingency plans have been floated since Lehman Brothers filed for Chapter 11 on September 15, 2008. There was also consensus, however, that there is still a long way to go before having an effective process for crisis management and resolution.

Presentation and Discussion

Cross-Atlantic Implications of the Greek Crisis

There was widespread recognition that Greece's finances are on an unsustainable path and that IMF support alone would not be enough to close the budget hole. Discussions emphasized that the U.S. government does not necessarily hold strong views on the Greek crisis, nor does it have any appetite for another financial crisis. Significant differences emerged among participants on whether conditionality on Greece can be enforced within the EU, on the impact of IMF intervention on the Euro's future and credibility, and on where to find the money to close the Greek deficit.

"TOO GREEK TO FAIL?"

Participants recognized that Greece's finances are on an unsustainable path. The Hellenic country has refinancing needs in excess of €43 billion until the end of the year 2010 (around 18% of nominal GDP as of 2009) and an estimated budget deficit for 2009 of 12.7% of GDP. Moreover, growth is expected to stagnate in the coming years, and the public debt is forecast to balloon to 152.5% of GDP in 2014 from 113.4% of GDP in 2009. Some sources estimate the cost of a Greek bail out—to stabilize public finances—to be €75 billion, around 40 times the Greek quota at the IMF.

Some participants thought that other Member countries should not rescue Greece, which has consistently falsified its public accounts and used derivatives to embellish its national figures in the period preceding the accession to the Euro. These participants expressed concerns that bailing out Greece would promote moral hazard in Europe and contended that the intergovernmental approach does not impose strict conditionality criteria, creating a "too Greek to fail" problem. Others strongly disagreed, arguing that

the European Union is a project founded on solidarity, and the role of partners is to help in moments of need. More cynically, they maintained that saving Greece would be much cheaper than risking a demise of the Eurozone.

U.S. VIEWS ON THE GREEK TRAGEDY

In discussions, it emerged that Washington has no strong views on the Greek crisis. Some believed that the Obama Administration would favor the creation of a European Monetary Fund (EMF), since stability in the Eurozone is generally beneficial to the U.S. economy. Others noted, however, that the U.S. has opposed similar funds in the past. In any event, the view was expressed that the EU cannot adopt such a solution in the short run since it requires legal changes to the EU treaty. Washington would not be opposed to either a combined IMF-EU rescue package or a purely European solution, provided that it does not have to come up with extra money. In short, as long as the EU contains the Greek

problem without U.S. help, Washington would be supportive of decisions taken in Brussels to avoid another financial crisis.

MORE OR LESS EUROPE?

Many considered the Greek crisis as an opportunity to progress with European integration. The view was expressed that European leaders should accelerate the integration of fiscal policies in the Eurozone, create the EMF, and start issuing “Eurobonds” with the full backing of the ECB. They argued that IMF intervention in European affairs would send the wrong signal to financial markets, undermining the prospects of the Euro as a global reserve currency and the credibility of the Eurozone. The other side retorted that IMF intervention has worked smoothly in Hungary and Latvia, even though these are not members of the Eurozone. They also added that the Lisbon Treaty was just ratified, and neither the public, nor interest groups, nor politicians have any appetite for further institutional reform.

INTERNATIONAL CONTAGION

A minority view considered debt restructuring as a viable option to Greece’s problems. They argued that default should be on the table when thinking about possible solutions to the budget crisis in light of the funding shortfall. A majority deemed such a solution unthinkable. A sovereign default in the Eurozone would have large and potentially catastrophic consequences. Contagion could spread easily beyond Europe to other areas of the world in a moment when financial markets are still fragile and sovereign entities are vulnerable due to large budget deficits. For instance, the devaluation of the Thai Baht in July 1997 had a massive impact on East Asia and beyond. Investors pulled out of the region indiscriminately, and in early 1998, the crisis spread to Russia, and subsequently to Argentina in 2001. Thus, avoiding a Greek default should be a priority.

GLOBAL AND EUROPEAN IMBALANCES

Participants pointed out that the Greek crisis reflects deeper structural problems in the European and global economy. To be sure, the Greek government is responsible for its financial troubles, but European and global imbalances create further fragilities in the world’s financial system. Within Europe, high savings and low wage inflation drive consistent German structural surpluses, which put pressure on other members of the Eurozone. Permanently fixed exchange rates do not allow adjustment, and Portugal, Ireland, Greece, and Spain (PIGS) are particularly weak due to their sluggish growth and large budget deficits. Participants were uncertain on how to address the problem.

CONCLUSION

A strong majority believed that Greece should not be allowed to default. Although Greek finances are on an unsustainable path and the creation of the EMF is not a short-term fix, rescuing the Greek government is the only solution to avert financial contagion. On the other hand, participants could not agree on whether the Greek crisis should be used to advance European integration. Moreover, there was no consensus on whether the IMF should be allowed to intervene in the Eurozone.

Presentation of Final Plenary Session

Harvard Law School Program on International Financial Systems

The Centre for European Policy Studies



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SESSION I

Managing Risk Post-Financial Crisis

Definition of Risk

- Tolerance of losses
- Information
- Losses should be borne by shareholders
- Interconnectedness



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Firm's Risk Management

- Tone at the top
- Corporate culture
 - What gets rewarded?
 - Innovation or risk management
 - Incentive
- Structure
 - CRO independence and resources
 - Access to board
 - Is it always possible?
 - Incentives



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Firm's Risk Management (2)

- Legal entity structure vs. group management
 - Simplify corporate structure
 - Living wills
- Less reliance on quantitative models and more qualitative risk management
 - How to implement it?
- Metric for interconnectedness
- Liquidity
 - Focus legal entities
 - “Balkanization”
- Accounting rules have business implications



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Supervision

- Standards?
- Better trained, paid, more experienced
- International training for regulators
- More co-operation
- Information sharing between supervisors



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Open Questions

- Stress tests?
- Externalize risk?
- How do systemic risk concerns get implemented at the firm level?
- What are the standards regulators should be looking for in risk managers?



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SESSION II

Implications of Capital Markets Reforms on Both Sides of the Atlantic

The New Normal

- Less liquidity
- Less credit
- Clearing: global/regional repository
- Higher risk premia
- Pressure on both market liquidity and bank balance sheets



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Prospects for EU-U.S. Dialogue

- Hedge funds and private equity
- Accounting: IFRS vs. US GAAP
- Resolution regimes
- International coordination
- Mutual recognition/equivalence
 - Lack of agreement may lead to lack of recognition



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Prospects for EU-U.S. Dialogue (2)

- IFIs lobby for global standards
 - Is a technical or political issue?
- EU reforms are ahead of U.S. reforms
- Generalized lack of trust
 - Politics/regulation/EU-U.S. dialogue (hibernation?)
 - Re-institute transatlantic dialogue
 - Have realistic expectations on equivalence
 - Set deadlines and goals



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Convergence / Divergence

Special Resolutions	_____
Accounting	Divergent
Hedge Funds	Convergent
Capital Adequacy	_____
Equivalence	Divergent
Market Structure	Convergent
Derivatives	Convergent
CRA's	Divergent



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Derivatives

- Trading
- Reporting
- Clearing
- CCPS
 - CDS concerning Europe should be in Europe
 - Even CCps
- DTCC



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Open Questions

- CRAs
- AFMD
- Volcker Rule
- Special Resolution Regime



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