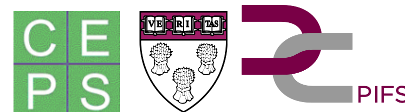
SYMPOSIUM ON BUILDING THE
FINANCIAL SYSTEM OF THE 21ST CENTURY:
AN AGENDA FOR EUROPE AND THE UNITED STATES



Swiss Re Centre for Global Dialogue • MARCH 21-23, 2013
Rüschlikon, Switzerland

AGENDA

Thursday, March 21

6:00-6:40 p.m. **COCKTAIL RECEPTION** Foyer

6:40-6:45 p.m. **WELCOME AND INTRODUCTORY REMARKS** Forum A&B

- Philippe Brahin, Head Governmental Affairs & Sustainability, Swiss Re

6:50-8:00 p.m. **KEYNOTE ADDRESSES** Forum A&B

- Daniel Gallagher, Commissioner, U.S. Securities and Exchange Commission
  Introduced by: Hal Scott, Nomura Professor and Director, PIFS, Harvard Law School
- Karl Soukup, Acting Director, European Commission, DG Competition, Financial Services Directorate
  Introduced by: Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies

8:00-10:00 p.m. **DINNER** Villa Dining Room

10:00 p.m. **AFTER-DINNER COCKTAILS** Lodge

Friday, March 22

7:00-7:45 a.m. **BREAKFAST**

8:00-8:30 a.m. **KEYNOTE ADRESS** Forum A&B

- Peter Praet, Member of the Executive Board, European Central Bank
  Introduced by: Wolf Klinz, Chairman, Special Committee on the Financial, Economic, and Social Crisis, European Parliament

8:35-8:55 a.m. **PANEL SESSION** Forum A&B

The New Financial Paradigm, Volcker, Vickers and Liikanen:
implications for business models, supervision and stability

- Gregory Baer, General Counsel for Corporate and Regulatory Law, JPMorgan Chase
- Daniel Trinder, Global Head of Regulatory Affairs, Deutsche Bank AG

9:00-10:15 a.m. **SMALL GROUP SESSIONS**

GROUP	ROOM	FACILITATORS	REPORTERS
1	Forum A&B	Elizabeth McCaul, Mitch Coen	Bill Grimes
2	Seminar 1	Sebastian Fairhurst, Steve Albrecht	Simon Gleeson
3	Seminar 2	Ken Dam, David Benson	Sven Kasper
4	Seminar 3	Lisa Rabbe, Al Iuppa	Ed Nalbantian
5	Seminar 4	Richard Kaye, John Siena	Patrick Kenadjian
6	Library	Lara de Mesa, John Houston	Diego Valiante

10:15-10:25 a.m. **REFRESHMENT BREAK** Foyer

10:30-10:50 a.m. **PANEL SESSION** Forum A&B

Reciprocity and extraterritoriality in post-crisis rules and its Impact on Trans-Atlantic Financial Markets

- Stefan Gavell, Executive Vice President and Head of Regulatory, Industry, and Gov't Affairs, State Street
- Christopher Bates, Partner, Clifford Chance LLP

11:00-12:15 p.m. **SMALL GROUP SESSIONS**

GROUP	ROOM	FACILITATORS	REPORTERS
1	Forum A&B	Chris Bates, Nick Collier	Bill Grimes
2	Seminar 1	Ed Bowles, Ruth Wandhofer	Simon Gleeson
3	Seminar 2	Wolf Klinz, Javier Arias	Sven Kasper
4	Seminar 3	James Elles, Edouard de Lencquesaing	Ed Nalbantian
5	Seminar 4	Dan Waldman, Nick Reinhardt	Patrick Kenadjian
6	Library	Tom Huertas, Dominique Graber	Diego Valiante

12:20-1:15 p.m. **BUFFET LUNCH** Foyer

1:20-1:50 p.m. **KEYNOTE ADDRESS** Forum A&B

- Jean-Pierre Danthine, Vice Chairman, Swiss National Bank
  Introduced by: Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies

1:55-3:30 p.m. **PANEL SESSION** Forum A&B

The Role of Long-term Investors and long term investment instruments in economic growth

Chair: Stephen Albrecht, Regulatory Leader, Europe, GE Capital

- Jerome Haegeli, Managing Director, Head Investment Strategy, Swiss Re
- Peter Skinner, Member of the European Parliament
- Edouard de Lencquesaing, CEO, European Institute of Financial Regulation (EIFR)

3:30-6:30 p.m. **FREE TIME & REPORTERS MEETING** Seminar 2

6:30-7:15 p.m. **COCKTAIL RECEPTION** Foyer

7:30-8:15 p.m. **KEYNOTE ADDRESS** Forum A&B

- Hermann Geiger, Group General Counsel, Group Management Board Member, Swiss Re
  Introduction*:* Hal Scott, Nomura Professor and Director, PIFS, Harvard Law School

8:15-10:00 p.m. **DINNER** Villa Dining Room

10:00 p.m. **AFTER-DINNER COCKTAILS** Lodge

Saturday, March 23

7:15-8:00 a.m. **BREAKFAST**

8:15-8:45 a.m. **KEYNOTE ADDRESS** Forum A&B

- Susan Baker, U.S. Treasury Financial Attaché for Europe, U.S. Department of Treasury
  Introduced by: Hal Scott, Nomura Professor and Director, PIFS, Harvard Law School

8:45-9:45 a.m. **PANEL SESSION** Forum A&B

The implications of Cyprus for Europe and the U.S.

- Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies
- Hal Scott, Nomura Professor and Director, PIFS, Harvard Law School

9:45-10:45 a.m. **P R E S E N T A T I O N & D I S C U S S I O N** Forum A&B

The New Financial Paradigm, Volcker, Vickers and Liikanen: implications for business models, supervision and stability

- Rachel Lomax, Chair of the International Regulatory Strategy Group, City of London
- Alan Houmann, Regional Head, European Government Affairs, Citi

10:45-11:00 a.m. **R E F R E S H M E N T B R E A K** Foyer

11:00-12:00p.m **P R E S E N T A T I O N & D I S C U S S I O N** Forum A&B

Reciprocity and extraterritoriality in post-crisis rules and its Impact on Trans-Atlantic Financial Markets

- Jose Luis Guerrero, Co-Head of Global Markets, HSBC Bank Plc
- William Marcoux, Partner, DLA Piper LLP

12:00-1:00 p.m. **C L O S I N G B U F F E T L U N C H** Foyer

Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States, March 21-23, 2013

The tenth Europe-U.S. Symposium was held in Zurich, Switzerland from March 21-23, 2013. Sessions included the implications for financial institutions of structural restrictions imposed through policies such the Volcker Rule, the impact of reciprocity and extraterritoriality in post-crisis U.S. and European regulation, the role of long-term investors and long-term investment instruments in economic growth, and the Cyprus banking crisis. Participants expressed concerns about the effects of new regulations on the financial industry, as well as the problems posed by regulatory divergence between Europe and the U.S. They also discussed ways in which long-term investors such as insurance companies and pension funds could contribute to long-term investment. Finally, they discussed the banking crisis in Cyprus and debated key elements of the emerging bail-out agreement. As in previous years, the Symposium provided a forum to discuss the new economic and regulatory environment, as well as its likely effects on the financial sector.

Session One: The New Financial Paradigm, Volcker, Vickers and Liikanen—Implications for Business Models, Supervision and Stability

Session One addressed new policies in the U.S. and Europe that sought to reduce problems of systemic instability by imposing structural solutions on financial institutions. These included the Volcker Rule and the ringfencing proposals made by the Vickers Commission and in the Liikanen Report. Discussions revolved around whether structural solutions would contribute to prevention of future financial crises, whether other policies might be more effective in achieving that goal, and how banks should adapt to the changing regulatory environment. Many participants expressed skepticism about whether structural solutions would accomplish their objectives and about whether the costs to financial institutions could be justified.

What problems do structural solutions solve?

Participants identified four main rationales that proponents had advanced for these policies: the problem of too big or too complicated to fail, the effective subsidization of risk-taking in the form of deposit insurance, the inherent riskiness of market-based financial activities compared to traditional banking, and the observation that banks may live globally but they tend to die nationally. Many participants questioned whether structural solutions would effectively address the problems that they were designed to resolve, or in some cases whether the problems really existed at all.

Participants noted that one of the common assumptions of proponents of structural solutions was that traditional banking was inherently less risky than other activities, such as market-based trading. Many strongly disputed this assumption. They pointed out that the core problem leading to the financial crisis had been traditional banking activities, in particular mortgage lending, even though contagion had in many cases traveled through securitized assets and derivatives. Indeed, some participants argued that market-based activities were actually less risky than traditional banking, as they offered diversification, liquidity, and an opportunity for hedging. A few participants also argued that mark-to-market artificially made market-based activities look more dangerous than traditional banking activities, because losses in trading would appear immediately, in contrast to loan losses that would typically be recognized only gradually.

More generally, many participants cited evidence that the structure of financial institutions did not correlate with performance during the financial crisis or in general. If financial institution structure had nothing to do with the crisis or the overall riskiness of a financial institution, they asked, why would structural solutions mitigate the future likelihood of crises and taxpayer bailouts? In response to proposals for breaking up banks in order to reduce their size, a number of participants made a similar argument—i.e., that size had not been a determinant of performance during the crisis, so there was no clear rationale for determining that a given bank should be broken up because it was too big.

These participants felt that other policies would more effectively address the systemic risks posed by large banks.

Some participants strongly disagreed with these assessments, however. They noted that in a number of European countries, most notably the UK and Switzerland, the banking systems held deposits that were equivalent to several multiples of GDP, and that therefore local conditions called for structural solutions such as ringfencing. Thus, they endorsed the Vickers approach. This raised the final rationale for structural solutions: the expectation that, as Mervyn King put it, "global banks are global in life, but national in death." If national regulators could not trust international counterparts to honor agreements for how to resolve a cross-border bank failure, then they would have an obligation to segregate funds in advance. While participants appeared to consider this the strongest argument in favor of assertive action by regulators, many disagreed with the idea that ringfencing was in fact the best way to manage that risk. A number of participants expressed doubt that simplifying banks' structure would necessarily simplify their resolution in the event of failure; adding multiple layers of national ring-fencing, meanwhile, would only make the situation more complicated. In contrast, some noted with approval the Swiss example which focused on resolvability without requiring the major Swiss banks to conform to specific structural solutions such as ringfencing.

Finally, participants raised the possibility of a variety of side effects that could adversely affect the U.S. and European economies and financial systems as a result of structural solutions. In addition to the loss of diversification benefits for individual financial institutions, many participants worried that the elimination of proprietary trading and other structural solutions would inevitably reduce the availability and liquidity of a variety of securities and derivatives globally, which would have the dual effects of raising costs for end-users and reducing the feasibility of hedging their risk. Reduced liquidity in financial markets could reduce the willingness of companies to invest risk capital and thus negatively impact economic growth in Europe and the U.S.

Some participants also worried about competition, particularly within Europe, whose financial markets and banking systems were seen as more concentrated than in the U.S. Although some structural solutions would seek to limit size, which would usually be seen as promoting competition, these participants argued that the exit of major financial institutions from smaller markets (e.g., derivatives) would actually restrict the number of players and thus have anti-competitive implications. Other participants expressed concern that, as banks withdrew from financial markets, transactions may move from the banking sector to less regulated sectors. While not all participants saw shadow banking as more risky than traditional banking, it was agreed that this was not the outcome that regulators were hoping for.

Living with structural solutions

Although most participants were strongly critical of structural solutions—with some characterizing them as "a bad idea whose time has come"—they understood that financial institutions would have to live them. They noted that the Volcker Rule had already been legislated through the Dodd-Frank Act and that the UK government stood behind the

conclusions of the Vickers Report; while the specific actions that would arise from the Liikanen Report remained undecided, they recognized that some sorts of structural solutions would likely be introduced throughout the eurozone as well. Thus, there was significant discussion of how the laws would be implemented and what that would mean for financial institutions. Some participants warned that structural solutions might well be applied to insurers at some point as well (e.g., if an insurance company were designated a SIFI under U.S. law), with possible ringfencing between traditional and non-traditional businesses.

Participants agreed that, regardless of the merits of structural solutions, there would be significant challenges to effective implementation. A major issue, which applied particularly to the Volcker Rule, but also potentially to European regulation, would be defining which activities would be allowed or not allowed by a given financial institution. The example that many raised was the difficulty of defining proprietary trading (in which banks would not be allowed to engage under the Volcker Rule) and market-making (which would be permissible).

Participants also saw cross-border challenges to implementation. A major issue was extraterritoriality, which was discussed in detail in Session Two. Some participants also saw potential effects on the competitiveness of financial institutions based in or operating in jurisdictions that enforced structural solutions.

Further complicating matters, participants agreed that structural solutions would likely vary by jurisdiction, in response to local conditions, including size and concentration of banking system, level of development of financial markets, and prevalence of non-bank financial intermediaries (insurance companies, pension funds, money market funds, hedge funds, etc.). Participants agreed that, if structural solutions were to be imposed, they should take such national differences into account. Still, some participants raised the possibility that not having uniform approaches would affect efficiency or competitiveness of financial institutions, and may even create new opportunities for regulatory arbitrage.

Financial institutions that would be subject to one or more of these rules continued, moreover, to face considerable uncertainty as to how they would be applied, how they would interact with other rules, and whether existing business models would remain viable. With the details and the implementation date of even the Volcker Rule still unknown, banks would not be able to plan in a rational way for how to change their structures and strategies to meet the new regulatory environment. Other financial institutions, as well as securities and derivatives end-users, would also face considerable uncertainty as to whether banks would still be able to function in financial markets as competitors or counterparties.

Politics of structural solutions

Thus, most participants saw the arguments in favor of structural solutions as problematic and many expressed serious concerns about their effects on both banks and the financial system. Instead, they saw a political logic to their adoption.

Participants suggested three reasons why structural solutions had proved to be appealing to politicians and the general public. First, they noted that structural solutions provided an apparently clean solution to a simple story line: banks were engaged in risky business, so the solution should be to restrict their ability to engage in risky business. They also felt that structural solutions, particularly those that sought to make financial institutions smaller and perhaps less profitable, appealed to a desire for retribution against the financiers who had brought on the crisis. Finally, some participants saw a less negative political justification. They began from the premise that there would be future crises, and that those crises may require taxpayer bailouts, despite the efforts of governments to insure against it. They argued that enforcing structural solutions would allow governments to claim that they had tried every alternative, thus making future bailouts more palatable.

Looking at the larger picture, participants discussed what sort of financial system governments were trying to create. A number of participants suggested that politicians and publics were wedded to an anachronistic view of banking, with some even invoking the community bank in the film *It's a Wonderful Life* as an idealized model. They expressed serious concern that efforts to force finance into such a model would be both unworkable and dangerous.

Meanwhile, many participants focused on the trade-offs between stability and growth (although not all agreed that attempts to impose stability would actually work). They argued that, in the wake of the financial crisis, many political systems had shifted toward prioritizing stability over growth, and that appeals to competitiveness and dynamism would therefore have little appeal. Participants also agreed that the way in which political systems prioritized stability versus growth varied considerably by country, with many European countries having moved even further into the stability camp than the U.S.

Finally, there was some discussion of the ongoing EU politics of structural solutions. Participants asked whether the Liikanen and Vickers proposals were in effect done deals. While there appeared to be little doubt that the Vickers proposals would be implemented in the UK without much modification, participants were less certain about those of the Liikanen Report. They noted first that the Commission was still considering the report, and that its recommendations had received criticism from a number of quarters. A number of participants also noted the decisions by France and Germany to implement less restrictive versions of the Liikanen recommendations that would allow universal banks to continue to operate. They suggested that those decisions were meant to preempt the Commission and create a *fait accompli* (which some characterized as "Liikanen Lite") that would shape the way the recommendations would be implemented throughout Europe. In general, participants considered the French and German versions to be more palatable than the original recommendations, which gave them at least some comfort.

Other approaches to preventing taxpayer-funded bailouts

While participants generally disapproved of structural solutions as a means of improving the stability of financial systems for all the reasons noted above, they also acknowledged that there were serious problems that needed to be addressed. They recognized that

complex financial institutions, particularly those operating across borders, created systemic risk problems and they expressed concern about moral hazard and excessive risk-taking resulting from financial institutions that had become too big or too complex to fail. Most felt, however, that structural solutions would not address these problems as directly or effectively as other policy measures.

Alternative policies focused on capital and liquidity, risk management, and resolution of failed institutions. Participants felt that the importance of addressing these issues was confirmed by both logic and the experience of the financial crisis, in contrast with the skepticism they expressed toward structural solutions. They also noted that all of these were issues were being addressed in national or international policymaking, particularly capital and liquidity requirements.

The bulk of this discussion was devoted to resolution of failed institutions. Participants agreed that clear rules and adequate resources were key to quick and effective resolution of any financial institution, and that the challenges were compounded by organizational complexity and cross-border operations. They thus called for a two-pronged approach. On the regulatory side, they argued for the importance of clear and consistent resolution regimes (an area in which they saw many European countries as lagging) and proactive cooperation between regulators from different countries to clarify roles and responsibilities prior to an actual crisis. Most also felt that it was important that institutions be "resolvable"; while much of the discussion assumed the importance of resolution and recovery plans ("living wills") as a means of planning for the unwinding of a complex institution, some participants focused instead on simplifying legal structures and harmonizing basic definitions (e.g., of basic elements such as capital and deposits), which they saw as more important.

Participants also discussed ways of better managing financial institutions' risks. Many of participants focused on the financial institutions themselves. They pointed not only to the need to improve procedures for evaluating risk, but also called for better internal management and better corporate governance as essential elements in ensuring that risky operations in one area would not bring down the whole institution and that the incentives of managers and traders were properly aligned with those of shareholders. A number of participants added that better risk management would depend on the capabilities and behavior of supervisors as well, and argued for the importance of ensuring that supervisory bodies were properly funded and staffed to maintain consistent standards of risk management and corporate governance.

Finally, some participants suggested that the Swiss model of macroprudential regulation might be a good model for other countries. The key elements of that model were addressing orderly resolutions without taxpayer money even for the largest institutions, ensuring proper incentives for investors and management, and building in a countercyclical component. Rather than structural solutions like ringfencing or subsidiarization, the Swiss approach focused more on capital structures, such as contingent capital and other bail-in-able debt.

Despite the general agreement on the importance of improving resolution regimes, however, some participants still expressed skepticism that these policies would solve all the problems that advocates claimed. Two concerns were paramount. First, many participants were doubtful that resolution regimes would necessarily prevent the need for taxpayer-funded bailouts, either because of contagion effects or because for some European economies the scale of major financial institutions' obligations was beyond the capability of home-country insurance schemes. In the absence of an EU-wide (or, given the importance of Swiss financial institutions, a Europe-wide) banking union, taxpayers would inevitably be on the hook if a crisis were large enough.

Another concern was over cross-border resolution plans. A number of participants expressed concern over what they saw as the slow pace of cross-border resolution agreements as well as the slow pace of harmonization of resolution regimes (even, or especially, in Europe). Others focused on a separate problem: they worried that even if clear cross-border resolution procedures were agreed in advance, in the event of a really large financial institution failure, national authorities would have a strong temptation to violate those agreements in order not to have to participate materially in the bailouts of financial institutions based in other countries.

Session 2: Reciprocity and Extraterritoriality in Post-Crisis Rules and Its Impact on Trans-Atlantic Financial Markets

Session 2 addressed concerns about the cross-national effects of differing national financial regulatory reforms in the post-crisis period. Participants worried not only about the added compliance costs and uncertainty created by regulatory overlaps and contradictions, but also about the ways in which U.S. and European regulators were seeking to address differences. They saw a worrying trend toward extraterritoriality and threats of reciprocity instead of use of mutual recognition, equivalence, and exemptive relief to deal with cross-border issues.

The shape of extraterritoriality and reciprocity

Participants focused in Session 2 on the problem of extraterritoriality. They agreed that extraterritorial regulation was widespread under the U.S. and European financial reforms. For the U.S., much of the discussion centered on the Volcker Rule and swap-dealer designation, but participants pointed to a wide range of other regulations, including the Foreign Account Tax Compliance Act (FATCA), as creating legal obligations for foreign financial institutions and markets. Participants noted, for example, that the Volcker Rule could potentially apply to the global structure of a foreign bank with U.S. branches or any business of foreign banks with U.S. counterparties. As for Europe, the proposed financial transactions tax (FTT) was the most strongly criticized policy measure. Similar to the way in which Dodd-Frank Act could force non-U.S. entities that do swaps transactions with U.S. entities to be regulated by the CFTC, the FTT would in theory apply to any transaction anywhere in the world that either involved a European security or had a EU entity as party to the transaction. Participants also cited a variety of other measures that had been proposed or already decided, including aspects of the European Market Infrastructure Regulation (EMIR), Markets in Financial Instruments Directive (MiFID), Alternative Investment Fund Managers Directive (AIFMD), and various short-selling restrictions as having significant extraterritorial implications.

Participants acknowledged that differences in national or regional preferences, financial structures, and legislative calendars made regulatory convergence extremely difficult. However, they felt that extraterritoriality and reciprocity were not positive ways of dealing with differences. Thus, they discussed the possibility of mutual recognition, equivalence determinations, and exemptive relief as better options, although there were doubts raised about the effectiveness of these mechanisms as well.

In principle, there was considerable support for more widespread use of mutual recognition, but many participants criticized the process as slow and cumbersome. Some also argued that negotiating mutual recognition pacts would be even harder at a time when financial markets were still seen as vulnerable and financial regulation remained

highly politically charged. Several participants advocated more extensive use by supervisors of exemptive relief as a means of reducing the problems created by overlapping or contradictory rules. However, most of this discussion focused on equivalence. In discussing the benefits of equivalence, a number of participants cited flexibility and ease of implementation as major advantages over alternative approaches. Both of these advantages were seen to result from the fact that equivalence determinations would be made on a unilateral basis by national regulators.

Despite the general support for more extensive use of equivalence, some participants also raised cautions about potential obstacles. A major issue was the principles by which equivalence designations would be made. In the U.S., the basic principle was that foreign financial institutions would have to meet the U.S. standards when those were more stringent than their home regulations. The EU, in contrast, had decided on a principle of national system equivalency—in other words, regardless of whether a given foreign financial institution met the EU standards, it would not be allowed to operate in the EU unless it were determined that the home country regulatory system was equivalent. In other words, a higher U.S. standard would not be equivalent to a lower EU standards. This seemed to flow from the concern within the EU of the impact of "gold plating" on competition within a single market. Many participants considered this to be an unreasonable impediment to market access, as it would penalize all institutions from a given country, no matter how sophisticated or well-managed they were.

An additional serious barrier to mutual recognition arose from the fact that the EU sought to prevent foreign regulators from designating individual EU countries' regulatory regimes as equivalent. Although regulations throughout the EU could reasonably be considered functionally equivalent to those of the U.S., the quality of supervision and implementation of regulation was seen to vary enormously within the EU. Coupled with the EU insistence on reciprocity, this meant that for the U.S. institutions to gain full access to UK financial markets, the U.S. regulators would need to designate Bulgarian or Cypriot regulatory regimes as equivalent to the U.S., which most participants agreed was unreasonable.

This example raised questions about the uses of reciprocity. Although some participants felt that the principle of reciprocity might be essential to prevent financial protectionism, others worried about its potential for misuse. One concern was that the U.S. or EU might use the threat of reciprocity as a tool to force changes in the other side's regulations or, as in the example above, to try force the U.S. to make an equivalency designation for EU member states whose supervisory practices were not up to a high standard. Some participants also worried that the U.S. or the EU might use threats of denying market access to force changes on countries that were less powerful, regardless of whether convergence were appropriate for their financial systems.

Another issue raised about the mechanisms for managing discrepancies between national regulatory and supervisory systems was what some participants saw as divided authority in the EU (albeit still not as severe as fragmentation in the U.S. regulatory system). They cited the existence of multiple national supervisory agencies implementing rules that

were not fully synchronized with each other (despite the existence of EU-wide standards such as through EMIR, MiFID, etc.). A number of participants therefore welcomed the advent of the EU Single Supervisory Mechanism (SSM), arguing that it would solve problems of coordination within Europe and transatlantically. Others were more skeptical of the impact it would make on coordination with non-EU countries, although they acknowledged the benefits within the EU. Some participants also raised the issue of coordination within the Commission itself, between the SSM and the Directorate-General for Competition (DG COMP), arguing that the differing objectives of the two would generate uncertainty and raise compliance challenges.

Problems of coordination

Many participants expressed the view that the key challenge to regulatory coordination was a pervasive lack of trust. They saw a lack of trust domestically between the public and private sectors, as well as internationally between U.S. and European authorities. At the domestic level, politicians and regulators had decided that the only effective way of ensuring good behavior on the part of financial institutions in the wake of the crisis was through strict rules on capital, liquidity, risk management, business conduct, and function; in turn, financial institutions were wary about sharing information with regulators for fear it would be used against them. Mistrust between regulators on the opposite sides of the Atlantic was seen as being both reflected and aggravated by financial rulemaking that focused on domestic concerns rather than taking transatlantic counterparts' preferences into account. And many participants felt that the challenges of cross-border bailouts and resolutions in particular bred mistrust, as national regulators worried that they would end up bailing out foreign shareholders, creditors, and depositors. Thus, they might ignore the concerns of their foreign counterparts and act unilaterally to try to prevent such burdens to taxpayers.

Many participants saw the lack of trust as being exacerbated by institutional factors, both domestically and internationally. Part of the story was regulatory fragmentation. In the U.S., this was exemplified by both the multiplicity of regulatory and supervisory bodies and their often overlapping nature. This was seen as having been further complicated by changes made under Dodd-Frank, including the creation of the Financial Stability Oversight Council (FSOC). Europe, meanwhile, continued to have a financial regulatory regime that was fragmented along national lines, despite significant steps toward uniformity of regulation and consolidation of EU-wide agencies such as ESMA and EBA. The establishment of the ESM was also seen as a positive development in this regard. Moreover, even at the EU level, some participants significant problems of fragmentation and overlap, both in terms of overlaps between different units within the Commission (e.g., between the directorates-general of economy and finance on the one hand and competition on the other) and within the decisionmaking structure of agencies like ESMA and EBA (which include both representation from the national regulators and a requirement of Commission and Parliament approval for some decisions).

To further complicate coordination, some participants argued that regulators on both sides of the Atlantic—but particularly in Europe—had lost a great deal of regulatory discretion. This was seen as reflecting both the lack of trust between regulators and

industry and between politicians and supervisors on the one hand and overly complex decisionmaking structures on the other hand. The combination was seen to have fostered both risk aversion and lack of flexibility, thus significantly reducing the scope for cooperation across borders.

In thinking about how to promote better coordination, participants mainly considered three options. The first was the traditional one of relying on transatlantic regulatory dialogue. A number of participants argued that this was still the best avenue to manage the relationship, and that in fact significant progress was being made on a variety of regulatory differences.

A second approach was to endorse the role of an international organization in promoting coordination. Several participants pointed to the G20 or affiliated organs such as IOSCO, IAIA, the Financial Stability Board, or the Basel Committee as organizations that could lend legitimacy and support to transatlantic efforts. They noted as precedents the role of the G20 in setting the direction for global regulatory reform after the crisis, that of the FSB in defining and designating G-SIFIs, and that of the Basel Committee in developing capital and liquidity requirements for banks. They pointed out that these organizations also had the benefit of broad representation, and thus greater legitimacy. Other participants were skeptical. They argued that organizations like the FSB lacked their own independent staffing and capabilities, and that most such organizations were most effective at working out technical details when political leaders had already given clear direction. Some participants supported the idea of using these organizations for more limited purposes of providing objective information and analysis on the issues at hand. Here too, there was skepticism about their capabilities. However, some participants expressed optimism about the potential for the IMF’s Financial Sector Assessment Program (FSAP) to be the basis of fruitful discussions in the FSB that could lead to reducing discriminatory or extraterritorial aspects of regulations.

Several participants also raised concerns that, even if it added legitimacy, acting through the G20 or major international regulatory bodies such as the Basel Committee or IOSCO would create other problems due to the inclusion of a larger number and variety of countries. They pointed out that the U.S. and Europe remained the home of many of the largest and most sophisticated internationally-active banks, insurance companies, and investment funds, and had by far the most active derivatives markets. Thus, they argued that for a variety of financial sectors, EU-U.S. agreement would remain a precondition for global agreements. Some participants expressed hesitation about this idea, however. They pointed out that other markets around the world, particularly in Asia, were growing in importance, and suggested that it would not be either fair or politically sustainable over the longer term to build global rules on transatlantic deals.

Finally, a number of participants argued that the best way to enforce coordination of regulatory regimes and supervisory practices would be by including financial services regulation in the proposed EU-U.S. Free Trade Agreement. They felt that this would create a clear and enforceable legal framework that would ensure fairness and consistency in how each partner’s financial institutions would be treated in the other’s

market. They also made a case that coordinating on financial services through an FTA would bring the benefit of buy-in and commitment to success from top political leaders. Other participants strongly disagreed with that point of view. They argued that it would take years to conclude an FTA, if it were even possible, and the FTA negotiations would preclude necessary nearer-term coordination. A number of participants also argued that the enforcement mechanisms in an FTA would be too rigid to respond to changing financial situations—they made the case that financial supervision required a much higher level of discretion and flexibility of application than rules governing trade. Moreover, some saw it as one more layer of complexity to add to an already complex environment for coordination. They noted, for example, that international trade law and most FTAs deliberately carved out prudential financial regulation, at least partly to avoid potential conflict between trade officials and financial regulators.

Reciprocity and extraterritoriality: the new status quo?

Although concerns about reciprocity and extraterritoriality were widely held among participants, there was also an understanding that conflicting regulations were in fact being put into place in the U.S. and Europe. A number of participants argued that reciprocity and extraterritoriality would thus likely become an ongoing part of the regulatory landscape or, as some put it, "the new status quo." Thus, they felt that financial institutions would need to figure out how to adapt to a situation in which finance would not be as much of a global business as in the pre-crisis world.

Participants pointed to a number of looming deadlines for regulatory decisions or implementation that would adversely affect cross-border financial transactions and multinational financial institutions if U.S. and European regulators were not able to come to agreements on managing extraterritoriality or conflicting regulations. The impending implementation deadlines included ones for some of the most consequential of the post-crisis rules, including EMIR, AIFMD, and the Volcker Rule.

While participants were worried about whether regulators in Europe and the U.S. could succeed in working out a cooperative solution to conflicting regulations, they were perhaps even more worried by the uncertainty regarding what the rules would be. They noted that questions remained even on basic definitions and principles in some cases. One example was EMIR, whose tight deadlines coexisted with a very low level of disclosure as to what supervisors would expect of financial institutions. Under the circumstances, participants agreed that many financial institutions would be unable to plan even for how to comply with some rules, let alone do so efficiently.

Many participants predicted that the consequences of extraterritoriality and conflicting regulations would be fragmentation and regionalization of financial markets. They argued that this would lead to declines in liquidity and thus higher costs and volatility for investors and end-users, even though fragmentation was not actually the intent of the new regulations. Indeed, some participants argued that some cross-border business was already drying up, and predicted that a larger exodus was on its way. For example, one participant described situations in which some U.S. fund managers were already choosing

not to invest in European derivatives, as they did not trust that they understood what basic market conditions would look like in six months.

Participants agreed that the business areas most at risk would be those that were most global and those where U.S. and EU rules most diverged. Many felt that the biggest hit would be felt in derivatives. They argued that derivatives had been the most truly global market leading up to the crisis and that the U.S. and EU approaches to post-crisis financial reforms in derivatives had created a particularly large number of divergent rules. Meanwhile, both the EU and to a lesser extent the U.S. had created significant barriers to foreign participation in clearing houses, further complicating transatlantic transactions. And as already noted, disagreements over approaches to equivalence designations also threatened to divide transatlantic derivatives markets. At the same time, some cautioned that many rules on derivatives remained undecided, particularly in the EU, so that it was possible that the effects would not be as bad as feared.

Although much of the discussion about extraterritoriality and reciprocity focused on the effects on banks and derivatives markets (and to a lesser extent, the financial transactions tax), many participants cautioned that there was much more to come. They predicted that the transatlantic divergence in rules would soon hit a variety of other businesses, including money market funds, asset management, and credit rating agencies. At the same time, a number of participants worried that hedging opportunities would dry up even beyond derivatives, as new EU regulations that would affect repurchase agreements and securities lending came into effect.

Participants agreed that the fragmentation and increased regulation would likely have effects that reached far beyond financial institutions. They predicted that reductions in capital available to banks, as well as liquidity in a variety of securities and derivatives markets, would inevitably raise costs for borrowers, investors, and derivatives end-users, and reduce the availability of credit globally.

What can the financial industry do to mitigate the impact?

While there was a general sense of concern about the likely effects of conflicting regulations, extraterritoriality, and reciprocity, participants also agreed that they would be living with these changes for the time being and that simple opposition to the reforms would not prevent them from occurring. Thus, a number of participants raised the question of how the financial industry should be dealing with regulators to mitigate problems arising from inappropriate policies.

One suggestion was to try to change the policy discourse surrounding financial regulation. Several participants argued that the policy discourse had centered on punishing or containing the actions of greedy financiers who had created the crisis. That meant that when financial institutions sought to slow or prevent reforms, they would be seen as just trying to protect their own selfish interests. Thus, these participants argued, it would be essential to refocus their message away from the efficiency or profitability of the financial sector, and instead frame the discussion as how to promote economic growth, while emphasizing the connections between the financial system and the real

economy. One particular suggestion was that policymakers and publics should be reminded of the need for credit to support job growth and small and medium-sized companies. Also, going back to the discussion of stability versus growth, several participants argued that a case should be made that the U.S. and European economies, which needed to increase productivity growth to ensure pensions and health care for their aging populations, should be trying to make it easier and more attractive for investors to commit risk capital to new ventures, infrastructure, and other important uses.

Other participants saw their role in the policy process as more limited. They felt that it may not be feasible to reframe the discourse at a time when there was still considerable resentment of the financial sector, so instead they advocated restricting their role to providing information to policy makers. Several participants called for contributing to fact-based discussions, by making sure policymakers had access to appropriate economic research. Others were skeptical, arguing that the backing of financial institutions might actually tend to discredit such research as self-interested. On the other hand, they suggested that the financial sector itself should be proactive about collecting data, particularly in less-regulated sectors such as "shadow banking," where accurate information about activities and functions was lacking. They noted that, for some financial markets or types of financial institutions, there was very little reliable data.

Several participants also suggested that financial institutions should support regulators by offering constructive alternatives rather than resisting policies that they saw as unappealing. Some described their own experiences in working with regulators to improve policies even where they did not necessarily agree with the goals. Since the goals had already been set by elected officials, they had decided that they could do more to reduce the costs and other negative effects by clarifying trade-offs than by trying to dictate choices.

Even among those participants who felt it was important to engage with policymakers in these ways, there was considerable confusion as to which policymakers should best be engaged. Given the fragmentation of financial regulation and supervision in Europe and the U.S., some participants suggested that industry should seek to promote regulatory and supervisory consolidation, although many participants felt that was unrealistic. In the meantime, participants considered whether it would be more effective to work with EU-wide organizations such as EBA, ESMA, ESM, or ECOFIN (because they decide policy for the EU) or national authorities (because they might be able to act as a brake on EU activism, either through their roles in the decisionmaking of EU-wide organizations or because they would be in some cases able to set precedents at home for the EU as a whole). Finally, a number of participants commented on the growing profile of the European Parliament, which had previously had a much more limited role in financial policymaking. Thus, they cautioned financial institutions not to ignore the Parliament.

Session 3: The Role of Long-Term Investors and Long-Term Investment Instruments in Economic Growth

Session 3 addressed the role of long-term investors such as insurance companies and pension funds in meeting global needs. Based on projections for global infrastructure development, participants discussed how long-term financing could be mobilized for those purposes. Among other issues, they discussed the role of capital markets and how post-crisis regulation affected the behavior of insurers.

Global demand for long-term investment

One of the premises of the discussion in Session 3 was the growing mismatch between global demand for long-term investment and what participants saw as the limited supply of long-term funds. Participants cited a number of studies that anticipated growing demand, particularly for infrastructure, as a result of both the development of emerging economies and deferred investment in developed economies. However, the availability of funds for such investment was seen as limited by a combination of factors, including fiscal austerity, de-risking on the part of some investors, and regulatory disincentives.

There was considerable discussion of the special challenges of funding infrastructure. Three issues were seen as particular challenges: the very long-term nature of infrastructure, the role of public authorities, and the particular complications of providing finance in emerging markets. Unlike other types of long-term investment, participants noted that infrastructure lending often had a 15-30 year payback horizon. However, many financial institutions' liability structures were much shorter. The involvement of governments, particularly in emerging markets, in the provision of infrastructure was seen by some as adding to the risk of investments. And participants noted the problem of currency mismatches caused by investing in emerging markets as an additional challenge.

Participants also raised the question of how to provide risk capital to small and medium-sized enterprises. This was raised particularly in the context of Europe, which they saw as suffering from a low growth environment. Given that SMEs account for the bulk of employment in any economy, they felt that it was urgent to improve avenues for SME financing. A number of participants argued that both infrastructure and SME finance were issues in which political and economic decisionmakers should be shifting their focus away from minimizing risk toward emphasizing growth.

Hindrances to long-term financing

Participants identified a number of impediments to the provision of long-term finance. With regard to infrastructure, they pointed to two particular problems. First was that governments, particularly in Europe, were not in a position to support infrastructural spending, because of both austerity policies and weak revenue growth due to economic stagnation or recession. Many expressed pessimism that these conditions would change in

the medium-term. Second, they noted that alternative institutions (such as private equity) or mechanisms (such as public-private partnerships) for infrastructure funding were lacking in Europe and in many emerging economies. In this regard, a number of participants pointed approvingly to the U.S., which they saw as having more investors with long time horizons, and where financing models such as turnpike authorities and Build America Bonds provided more options for infrastructure funding than in Europe. Some participants pointed out that the European Investment Bank and European Investment Fund could contribute parallel funds, but there were questions raised about their effectiveness.

Many participants noted that insurance companies and pension funds were the most natural private-sector providers of long-term financing; however, they were relatively minor funders compared to banks, whose term structures were much less appropriate. They expressed concern that insurance companies and pension funds were being stifled in their ability to provide long-term financing due to post-crisis regulation that overly prized stability over growth. One example noted by several participants was the way in which Solvency 2 would deal with risk weighting—for example, a 30% capital charge for 15-year BBB bonds (obligations that could well be issued by infrastructure projects). More generally, several participants suggested that, in the post-crisis environment, regulators were applying models of prudential regulation on insurance companies that made more sense for banks.

As for providing longer-term capital for SMEs, participants agreed that the continued dominance of bank lending in Europe was a serious impediment to SME growth. This was seen to be not only a result of slow or negative growth of bank lending but also a bias toward lending to larger or more established companies. While SMEs are often at a disadvantage in getting access to lending due to problems of scale, some participants argued that the problem was exacerbated in Europe by the reluctance of banks to charge SMEs higher interest rates to incorporate risk, which made them all the more wary to lend to SMEs.

Tax policies in Europe were also seen by some participants as disadvantaging long-term investment with regard to both infrastructure and SMEs. A number of participants argued that, ideally, tax regimes should incentivize long-term investment, but that in fact many of them penalized such investments. The proposed FTT was seen as particularly problematic, as it was expected to slash liquidity and reduce incentives for capital market-based investment. Several suggested that U.S. tax policy, including tax-free treatment of municipal and Build America Bonds, could be a good model for European governments if they were serious about wanting to encourage long-term financing.

Promoting long-term financing

Participants discussed several means of improving the supply of long-term financing. Some argued that the key would be reinvigoration of capital markets, which they saw as the most natural mechanism for long-term financing. In this regard, they expressed concern about what they saw as the inefficiencies of both primary and secondary markets. They noted that, while problems of U.S. capital markets had been discussed as financial

market center competitiveness issues in the years immediately prior to the crisis, the bigger problem was now their ineffectiveness in providing risk capital, particularly for SMEs. Several participants argued that the situation in Europe was worse, with some expressing envy of the U.S. municipal bond market in particular. In both Europe and the U.S., the weakness of asset-backed securities markets was also seen as a problem for long-term investment, as were market fragmentation and illiquidity.

Given the weakness of public markets, a number of participants suggested that alternative investment vehicles could step into the breach. It was noted that in the U.S., a great deal of long-term investment was coming from private equity, venture capital firms, and other asset management firms. In Europe, such institutions were seen as significantly less developed; moreover, a number of participants argued that regulations such as MiFID further complicated their development. There was, additionally, some mention of sovereign wealth funds, but no extended discussion. Several participants also suggested that alternative investment funds and others should consider direct lending as an option, particularly in Europe, although a number of participants expressed skepticism that they would have the capability to make lending decisions effectively.

Finally, many participants reiterated the hope that impediments to long-term investment by insurance companies would be lifted. They pointed out that insurance companies had long time horizons that matched the needs of infrastructure development, as well as strong capital bases.

Session 4: The Cyprus Crisis

In Session 4, participants discussed the ongoing banking crisis in Cyprus. After reviewing a timeline of the crisis to date, they addressed the origins of the crisis, possible solutions, and lessons learned, as well as the implications for the future. Many participants expressed a high level of disappointment with the performance of European institutions and political processes.

Cyprus and Europe

One of the recurring themes of Session 4 was amazement at how bad the situation in Cyprus had been allowed to get. Participants noted that, even though Cyprus was subject to EU and eurozone regulations, its financial system had functioned essentially as an offshore tax haven and money-laundering center. Thanks to expatriate (most notably, but not exclusively, Russian) inflows, the banking system had a deposit base of approximately eight times GDP; combined with lax prudential supervision and a bad bet on Greek debt, it had become too big to save without a massive regional effort.

Participants agreed that the crisis was a failure not only on the part of Cyprus, but also on the part of EU institutions and especially the eurozone. There was evidence that some EU institutions, including some Parliamentarians, had raised concerns earlier about Cyprus' status as an undersupervised offshore banking center, but no action had been taken until the crisis hit. Moreover, many participants felt that the response of the Commission and the ECB had been haphazard and confused.

There was considerable discussion of the role of the ECB's Emergency Liquidity Assistance (ELA). Some participants felt that the ECB had been inconsistent, swinging between threats to deny and offers to extend ELA, all the while saying it would do whatever was necessary to prevent contagion in the rest of the Eurozone. Others argued that the ECB was consistent in its intentions but had been forced into the role of "enforcer," using the threat of withholding ELA to force an agreement. Several pointed out that, once authorized, it would take a 2/3 vote in the Governing Council to cut off ELA, so the ECB would be reluctant to extend assistance until a viable deal had been made. And a number of participants agreed that the ECB was wise to be attaching conditions to ELA, since it was putting significant funds at risk.

Going forward, one of the big questions on participants' minds was how it would affect proposals for a regional deposit scheme. Some participants argued that the Cyprus crisis demonstrated definitively that no one country should be expected to be able to manage a banking crisis on its own; rather, that the EU would be better off adopting a regional risk-pooling system akin to that of the U.S. Others felt that the real lesson was that true regional risk-pooling in the EU was politically unfeasible.

Deposit insurance and crisis management

The fate of depositors was a matter of considerable discussion in Session 4. Many participants were appalled that insured depositors might be asked to share part of the

burden. They argued that this would throw the whole idea of deposit insurance in eurozone countries into question, with potentially disastrous effects if doubts were to arise about banks in some countries. While this assessment was widely held, a few participants disagreed with it. One counterargument was that implicit EU guarantees for Cyprus depositors had subsidized higher returns for years, so it was not unreasonable to tax them. Others echoed the Commission, arguing that the agreement did not actually constitute a violation of deposit insurance guarantees, because depositors were simply being charged a tax and in any event the banks had not yet been declared insolvent, so in principle the government was not yet tapping deposit insurance. (It was also noted that Italy had put in place a similar tax in 1992, but had imposed the tax swiftly and decisively, unlike in the Cyprus case.) Overall, however, most participants expressed the view that the banks were clearly insolvent and were only able to maintain even an appearance of still being in business because depositors could not access their money.

Participants noted the surprising but reassuring fact that there had been no meaningful contagion to the rest of Europe so far. It was generally agreed that the reason for this was the ECB's publicly stated determination to take any measure necessary to prevent it. While some felt that the ECB had perhaps learned that lesson by observing the performance of the Fed during the U.S. crisis, an American participant cautioned that the Dodd-Frank Act had stripped authorities of key weapons to prevent contagion—not only would the Fed need approval from the Treasury Secretary for new liquidity mechanisms, but the FDIC would need a Congressional joint resolution to provide unlimited coverage of transaction accounts and money market funds would not be able to access the Stabilization Fund. Thus, the U.S. might be much more vulnerable in the next crisis.

The last element of crisis management was capital controls. Despite the legal and economic difficulty of implementing capital controls inside the eurozone, participants felt that such controls would be necessary. They noted that in the Cyprus case, it had been made somewhat easier by the fact that there were only a small number of transnational banks.

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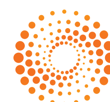

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