Finance Watch Conference

Five Years On - What next for the financial reform agenda?

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Key Points

- **'Too-Big-To-Fail'**: Panellists agreed that European banks are still volatile and 'too-big-to-fail' has not been sufficiently addressed. Adrian Blundell-Wignall (OECD) said that the OECD wants to see 'too-big-to-fail' addressed from the beginning in a preventive measure. Alain Deckers (European Commission) said that Member States can no longer afford to bail-out the banks again. Sheila Bair (former FDIC Chair) highlighted that 'too-big-to-fail' is an issue of market perception related to interconnectedness. This leads to a loss of market discipline. The assumption that G-SiFIs are safe gives cheap funding and an incentive to use a lot of debt. In consequence, this makes the system much more unstable. Bair warned that 'too-big-to-fail' is also bad from a market standpoint, bad from a political stability perspective and atrocious from an ethical standpoint. In addition, it makes market access more difficult and harms competitiveness. This is important to remember as Europe considers how to structure its resolution mechanism.
- **Resolution**: Bair also stressed that the European recovery and resolution legislation should be hard-wired against bail-outs to provide political and practical clarity. Liquidity support should be used uniquely to ensure that the credit flows to the real economy are preserved. To absorb potential losses, institutions should also maintain a thick stack of unsecured debt with a minimum duration of two years. When it is provided, liquidity support must not be a protection for the shareholders and creditors of financial institutions. Furthermore, Bair warned that the way derivatives are treated in a traditional bankruptcy can be highly disruptive.
- **Structural Reform**: Blundell-Wignall strongly argued in favour of separating retail and investment banking. However, he critiqued the three major theories for ringfencing: (1) Volckers' rule implements a blanket ban on speculating on short-term price movements, but it also says the bank can do market making. Activities like market making, originating and underwriting necessitate making a book. (2) To get flagged for separation under Liikanen, a bank has to have a certain percentage of for-sale securities. The OECD finds that this is the wrong variable and that derivatives provide a far better indication of distance to default. (3) Vickers is the closest to the OECD's suggestion. The only problem Blundell-Wignall sees with Vickers is that it would ring-fence the retail bank, but not all the other subsidiaries of the bank. The OECD suggests a non-operating holding company structure, using derivatives as a variable. Deckers said that the Commission is about to publish its view on the subject. Its suggestions will look at variables including derivative exposure as a measure, on both the asset and liability sides. Blundell-Wignall said the OECD perspective is that separating subsidiaries breaks monopoly and encourages the fair pricing of risk. He considers this a competition policy that would increase lending. In her keynote speech, Bair said that structural reform and subsidiarisation over the long term would give regulators more options in terms of resolution and making international operations easier to settle.
- **Leverage**: Blundell-Wignall argued that the 3 per cent a leverage ratio required by Basel III is not sufficient; Lehman Bros had 3 per cent leverage ratio when it failed. This is why the OECD recommends a minimum of a 5 per cent no risk-weights leverage ratio. Robert Jenkins agreed that Basel III does not make any significant reduction of excessive leverage.
- **Counterparty risk**: Blundell-Wignall said that the treatment of counterparty risk under Basel has one major flaw: the CVA-charge works on netting pools. Netting is a settlement concept that has nothing to do with market risk. To base the CVA-charge on netted derivatives is a crazy thing to do because the position can change in the course of the same day. Furthermore he stressed that European banks are still volatile; the commercial banking subsidiary should have a maximum derivatives ratio imposed, so that no more than 10 per cent of its business can be in derivatives. The investment subsidiary would be able to have a larger derivatives exposure, but its creditors would be unable to chase after the assets of the retail subsidiary.

- **Democratic accountability**: Professor Walter Mattli (University of Oxford) said that that regulatory change produces winners and losers and potential losers will fight at every stage of the reform process. Some potential losers are economically very strong. The financial sector is dominant part of the economy, but economic dominance must not become dominant politically. Such an outcome can be avoided by invigorating both institutional checks and balances and political checks and balances. Sharon Bowles MEP (ALDE) said that technical and political authorities outweigh the impact of democratic institutions on financial regulation. In Parliament, things move so fast that important discussions disappear into shadows meetings and in the opacity of trilogues. Transparency on lobbying needs to be enforced much more strongly. Robert Kuttner (The American Prospect) wondered whether there is something inherently anti-democratic in the complexity of modern finance, compounded by the fact that global regulation has no democratic accountability to regular people. Jenkins added that lobbying has wrongly convinced policymakers that society has to choose between safety and growth, safety of banks and shareholder value and between a safe banking system and a competitive financial market place.
- **Derivatives:** Richard Raeburn (EACT) said that only about 5 per cent of outstanding derivatives trades are actual end-user, non-financial counterparty transactions. Thierry Philipponnat (Finance Watch) questioned whether there is a need a $700trn derivatives market at all, if only 5 or 8 per cent are used for hedging. He pointed out that in 1988, companies managed their risks successfully although the market was ten times smaller. The market managed fine back then. Since then the derivative market has grown 540 per cent, bond markets have grown 140 per cent and equity markets have grown 35 per cent. He stressed that this is more than just hedging and that the too-big-to-fail subsidy is feeding this market. John E. Parsons said that derivatives are abused as often by institutions branded 'non-financial' as they are by those branded 'financials'. Therefore, 'non-financials' must not be exempted from regulation. Jennifer Robertson (European Commission) agreed that there must not be any loopholes in the regulation, as these would benefit the shadow banking system. One case where this is very important is the special purpose vehicles to circumvent EMIR.

SUMMARY

Introduction Thierry Philipponnat (Secretary General, Finance Watch) welcomed all speakers and delegates. He explained that this conference was taking place in the context that five years have passed since the last financial crisis. The objective of the day is to debate what has been done on financial regulation in the last five years and what is still to be done in future. What should be on the agenda of the EU institutions in the crucial time following the upcoming European elections and the Commission's renewal?

In anticipation of the conference, Philipponnat has been discussing its subject with different types of stakeholders. The answers he has received varied between different types of stakeholders; policymakers appeared to think they have accomplished their mission to reform the banks following the agenda set by the G20 four years ago. The financial services industry generally responded that regulation has already gone too far. Analysts and civil society representatives tend to think not enough has been done on the system's most crucial problems. He acknowledges that, from a policymaker's point of view, much of what was set on the G20 agenda has been accomplished. This was a tremendous amount of work, but did not address the issue of 'too-big-to-fail'. From the industry's viewpoint there was too much intervention. The many thousand pages of regulation are a challenge to master and take much attention away from other aspects of the business. From a societal perspective, however, it is questionable whether the G20 addressed the right issues to start with. For example, on derivatives, the regulation on central clearing is indeed fundamental, but the even bigger question of whether society needs a $700trn derivatives market at all was not addressed.

Philipponnat set the conference's aim to go beyond the individual stakeholder views and look at the bigger perspective. There should be an additional dimension in this debate: democracy. Democracy is not only about free elections but, as importantly, about the rule of law and about having elected officials working for the public interest without being captured by private interests. This does not mean that it is not legitimate for private interests to be expressed, but elected officials need to be clear and uninfluenced. This is not always the case when legislating financial regulation. Speaking about democratising the reform process, one must also keep in mind the tide of populism rising in the EU today. He thanked all stakeholders, including the industry, for being so willing to engage in this debate.

Session 1 - Banking: Mission accomplished?

Panellists (from left): *Peter Spiegel, Chief of Brussels Bureau, Financial Times (Moderator); Alain Deckers, Head of Unit, Banks and Financial Conglomerates II, DG MARKT, European Commission; Adrian Blundell-Wignall, Special Advisor to the Secretary-General on Financial Markets, OECD*

Alain Deckers opened by saying that policymakers have accomplished a lot. The Commission has been and remains committed to reforming the financial sector after the crisis. Even though it may seem like everything has calmed down by now, but the Commission is aware that the situation is still fragile.

What has happened so far? - Important regulation has been put in place; particularly in the area of supervision through the establishment of the new authorities. Recently, the Commission consulted on the structure of the supervision authorities. The assessment so far is that, as far as the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) are concerned, things are working relatively well, but there is still room for improvement. With regards to the European Systemic Risk Board (ESRB), there are some more fundamental issues, particularly related to governance. This will be the subject of a report, to be published later this year or on this early next year, but the Commission is not planning to legislate the issue.

What else has been achieved? -The new Capital Requirements Directive (CRD IV/CRR) and the establishment of the Single Supervisory Mechanism (SSM) will also contribute to a more stable financial system working in the interest of the real economy. Only recently the final texts of both files were published in the Official Journal. In the recent years, there were also other very important pieces of legislation, including the European Market Infrastructure Regulation (EMIR) or the Directive on Alternative Investment Funds (AIFMD) or the rules on short selling. These will all contribute to a more stable financial sector.

Nevertheless, important issues remain to be completed: for example the revision of the Markets in Financial Instruments Directive (MiFID II), where he hopes for an agreement before the end of the year. There are other important dossiers left on the table: there is still a lot of work on the new capital framework. The adoption of effective level II legislation needs to ensure the proper functioning of the new system. This will keep the EBA and the European Commission busy for a little while longer.

Beyond that, Deckers highlighted three challenges where progress is most needed: Firstly, there are still two missing elements in the financial regulatory framework: the adoption of the new crisis management framework consisting of the Recovery and Resolution Directive (RRD), the Single Resolution Mechanism (SRM) and the Directive on Deposit Guarantee Schemes (DGS), and progress on the question of the structure of the banking sector. Secondly, further progress is needed to ensure global regulatory convergence. This is a precondition for global financial stability. The financial system is too globally interconnected not to complete this issue. There will be regulatory arbitrage otherwise. Thirdly, corrective regulation has already been put in place, but there is still room for pro-active regulation. Particularly, he addressed the need for fine-tuning regulations so that they do not undermine the financing of the real economy. The most recent example of such fine-tuning is the postponement of the implementation deadline for Solvency II. A pro-active approach also means to look at what more is needed; particularly to ensure capital is used to best effect for the real economy and to put an end to the short-termism of the sector. This agenda is pursued in the Commission initiative on the long-term financing of the European economy. The Green Paper on the subject will be followed by an action plan early next year. Some aspects of it have already been proposed; such as the long-term investment funds. The Commission is also looking at other ways to provide incentives to shareholders to promote long-term investment. On structural reform and the follow-up to Liikanen, the Commission's impact assessment is in final stages. A proposal will be put forward very shortly. It will comprise a comprehensive assessment of possible options for reform, going beyond those coming from the Liikanen Report, taking into consideration national reform initiatives going on inside and outside the EU.

Why does structural reform need to be looked at? - Given the changes in the fiscal situation of many Member States, Member States can no longer afford to bail-out the banks again. This means that there is not only 'too-big-to-fail' but also 'too-big-to-address'. This is a dilemma the EU needs to address. Given this focus, it is clear that any proposal on structural reform will address only the largest and most complex banking groups, as described in the consultation paper. Despite the Member State actions on the matter, there is also a case for acting at a European level to ensure the effectiveness of the Single Market and the Banking Union. The proposal from the Commission will be published shortly. It will be looking at 'too-big-to-fail', but also will not propose anything that compromises growth and lending to the real economy.

Adrian Blundell-Wignall said that since the OECD first started speaking about reform, the circumstances have changed. In his keynote speech, he would like to concentrate on how the leverage ratios work and on the structure of the banking sector, a very important issue.

He explained a graph stating the earnings and capital markets capitalisation share of the financial sector in S&P500. In the US, the financial sector of the S&P500 companies took 6 per cent of the earnings of the S&P500 companies in the 1980s. Going forward to the early 2000s, the lead-up to the crisis, this number becomes 36 per cent of the earnings of the S&P500. Blundell-Wignall described this figure as staggering: the financial sector is supposed to oil the wheels of capitalism between real savers and real investors. It is not supposed not to take 36 per cent of the market. Yet, that is what happened! In the crisis, there was a big dip, but today, this figure is almost back to 16 or 17 per cent, heading up. Unless the structure of the sector is reformed, this figure will return to pre-crisis figures.

The financial sector itself does not promote economic growth. The financial sector is there to help real economy actors to generate growth, not to replace them. There are two big risks in the financial sector:

Firstly, leverage is a risk. Leverage means that there is an amount of equity capital in a bank, and then the bank builds up a lot of assets. So if those assets go down, compared to the liabilities they've committed to, other than equity, the equity value goes down. If the assets keep falling in value, the equity value can go to zero. At that point, the bank is moving into negative equity. Therefore leverage is very important. Leverage can be lowered by having more capital. The problem with the way the regulatory process is moving is that the Basel Tier I system takes the amount of capital the banks have and compares it to a denominator of risk-weighted assets. The assumption is that the amount of capital you hold is related to their risk weight. The banks themselves can determine what this risk-weight is. They run their own internal models and tell the regulator what they think the riskiness of their portfolios is. Naturally, there is an incentive for banks to say that their assets are not risky, because this means they will have to post less capital. The incentive is to reduce the ratio of risk-weighted assets to total assets ratio. So a bank with a €2trn balance sheet could reduce its risk-weighted assets to €1, and thereby still have a 100 per cent of the capital ratio. Globally systemically important financial institutions (G-SiFis) therefore reduce their risk-weighted assets to total assets ratio as much as possible. A rising capital ratio caused by a falling denominator means that the leverage risk can still rise. The OECD recommendation is for a straight leverage ratio. Basel suggests 3 per cent as a leverage ratio. This is not sufficient; Lehman Bros had 3 per cent leverage ratio when they failed. This is why the OECD recommends a minimum of a 5 per cent no risk-weights leverage ratio.

Besides the leverage risk, the second big risk is counterparty risk. The main cause for interconnection between banks is in the derivatives market. The $700trn world derivatives market in notional terms boils down to net exposures. The most important event in the financial crisis is exemplified the development of gross credit exposure (GMV-Netting) of derivatives and collateral. It shows the true open exposure against which collateral is needed. In the world derivatives market in 2006/2007, there was about $1trn collateral. In a crisis, the volatility between all the stocks and bonds and derivatives begins to change, thereby also changing the price-base for derivatives, as derivatives are based on volatility. The $1trn collateral held in 2006/07, went up to $4trn in 2012. This means that there is a $3trn margin call on the global system. Today, levels are already back to pre-crisis levels.

When the reform process started, policymakers did the best they could, given the circumstances. Basel III was a huge improvement on Basel II, but problems remain on structure and on leverage. The OECD says there has been too much policy made ‘on the run’. There needs to be more consideration of individual banks’ distance to default. This is information you get from the stock prices and the riskiness of a bank. Distance to default for US banks is fairly high. This is a good thing because it means that they are a long way away from default. The OECD considers a distance to default of three standard deviations as fairly safe. Most US banks now are well above three standard deviations. In Europe, it’s a completely different story. All it takes is a little bit of volatility to take down a bank. The case of Dexia exemplified this. Just prior to its failure, Dexia had one of the highest Basel Core Tier I ratios in the world: 11.5 per cent. Dexia failed because it couldn’t make its margin calls in its hedging and derivatives policies. Immediately as they were failing, their Core Tier I ratio was still 7.5 per cent, which is still above the requirements. What is the value of a measure, where you can still meet the requirements as you go into default? This is why there is something seriously wrong.

The second big suggestion of the OECD, besides the leverage ratio, is that banks should be separating the core deposit banking functions in a non-operating holding company structure (NOHC). In this scenario, both half stay within the group but creditors of the different subsidiaries cannot chase after the other subsidiary’s assets. If a bank has a relevant derivatives proportion in is balance sheet (something more than 10 or 15 per cent), then this bank should separate its deposit taking functions. Creditors of the investment banks should not be able to chase after deposit holders. An example of a very safe bank is Wells Fargo, because they have a derivatives portfolio of 7 per cent. As you go into riskier activities like market making and hedging, the percentage of derivatives will go up. This is when a bank becomes less safe. Therefore, looking at the derivatives as an indicator, it is easy to set a threshold beyond which a bank needs to separate its investment and commercial activities. The commercial banking subsidiary should have a maximum derivatives ratio imposed, so that no more than 10 per cent of its business must be in derivatives. The investment subsidiary can have 50 per cent of derivatives if it likes, but their creditors must not be able to chase after the assets of the subsidiary.

The OECD wants to see ‘too-big-to-fail’ addressed from the beginning in a preventive measure. All the resolution mechanisms are pessimistic measures are very well, but they do not actually change the system. A preventive measure alone can definitely end the reliance on taxpayer money. In the NHCH, the creditors of the investment bank know that they cannot go after deposit holders or government money, therefore their pricing of risk will go up. That investment bank becomes more risky because the implicit guarantee from the deposit taking part of the bank is no longer there. This is obvious, but banks are not keen on it, for obvious reasons.

Blundell-Wignall addressed the five main criticisms of banking separation:

1. *Lehman Brothers and AIG were not universal banks that could be considered for separation, and yet they caused systemic concerns*. - Had Lehman Brothers been operating in a world where the banks that were their counterparties, JP Morgan, Citi Group and others, had been separated, Lehman Brothers would have been trading with a high-risk segment of Citi Group, a high-risk segment of JP Morgan and so on. The risk would have been priced higher and Lehman Brothers would have made much fewer trades.
2. *It was not the G-SiFi banks that failed during the crisis; it was the specialised mortgage banks involved in the real estate boom busts in the USA, the UK, Ireland and Spain that mainly failed.* - The reason why those banks failed was because they got into bed with the big G-SiFi banks, instead of having the standard deposits and loans. They believed that if they kept pushing out into loans, they could be securitised and sold on. They pushed down interest rates on loans, went out into the higher risk area, because they were looking for products to sell into securitisation processes. They changed their business model, in other words.
3. *Separating core deposit banking will force investment banks into more wholesale funding, which the DTD model results suggest is a riskier business model feature.* - This means that the price in the investment bank would go up. Of course, as the price of risk goes up, the size of the business goes down. If you are a policymaker, that's what you want.
4. *It is legally too complex to separate assets and liabilities while meeting all of the tax and corporate laws of the country concerned.* - There is an example of an NOHC in Australia: Macquarie Bank. This shows this system is very possible; you just need to want to do it.
5. *That separation with full ring fencing of all subsidiaries is essentially Glass-Steagall, so why bother with NOHC?* - The OECD thinks that it is politically acceptable to legislate for a NOHC structure because the group stays together, still benefitting from synergies, but it is a safer group. He has nothing against Glass-Steagall style separation, but does not think it is necessary with the right legislation.

Peter Spiegel asked about the margin calls on derivatives. Is Blundell Wignall saying that this exposure would go down in case of separation?

Blundell-Wignall said that this would happen naturally. Risky derivatives deals are only made because a large banking group is guaranteeing for them. If there was a small, legally separate entity offering the same deal, it would not be acceptable. Every counterparty has to do three things to protect themselves: high initial margins, 100 per cent variation margins and third party custody. Derivatives are only cheap because of re-hypothecation. If you are able to not have third party custody, the cost of doing the trade goes down and the demand goes up.

Spiegel said that he was shocked that the European banks are so near to default, according to the OECD's calculation. Why is this?

Blundell-Wignall said the way the US has gone about this has been much better than the European way. At the beginning of the crisis, Europe's motto was 'hear no evil - see no evil - speak no evil'. The US acknowledged it was going to hell in a hand basket. All the work that's being done in Europe is going in the right direction but the starting point was all wrong. The biggest problem he sees is forbearance. If things go bad, banks are sitting on their balance sheet and the bank that doesn't have enough capital (which is the case in Europe) is in trouble. Forbearance means that there are loans and derivatives that have gone bad but banks engage in extend and pretend. This allows banks to deny the very existence of these bad loans. The problem of forbearance is costing the taxpayer a lot of money.

Deckers said that the Commission has drawn the comparison between European and US G-SiFis. From a capital position, the EU G-SiFis were slightly better, from a leverage point of view, the US G-SiFis were slightly better. In addition, a number of processes are trying to address this. The European Central Bank's (ECB) comprehensive balance sheet assessment is an essential element. There are also a number of asset quality reviews (AQRs) going on national level. The issue is being taken seriously. He would certainly dispute the notion that the European banking system is in a terrible condition.

Blundell-Wignall pointed out that in the US banks are seen to be lending again and a recovery is palpable; while in Europe there is deleveraging going on. He asked whether Deckers is saying there is no reason for this. That would be saying that European banks are just being stupid.

Deckers said that he did not say banks were being stupid. These developments are caused both on the supply side and on the demand side. The overall macroeconomic condition of Europe at the moment is also still weaker, which also affects the demand side of lending, so it is not just a question of banks' tightening.

Spiegel quoted EU Commissioner Rehn who said that that the reason the ECB needs to stress test is because the first set of stress tests and reviews done by the EBA are viewed as not credible. For reasons to do with national interest groups, national supervisors didn't follow the EBA recommendations. Rehn clearly made the case that in the past, European asset quality reviews weren't real. Is this portraying a different narrative from what Deckers describes?

Deckers said it was far from his mind to contradict the Commissioner. The ECB balance sheet assessment will be supplemented by an AQR, conducted in cooperation with the EBA. This will be important. The European Commission is not complacent and is working on this in a serious manner. There is strengthened cooperation on European level now.

Spiegel asked about the Commission's view on structural banking reform. Why is there no global strategy? How much scope is there for action on EU level?

Deckers said that structural reform was not part of the G20 agenda; therefore jurisdictions have proceeded on their own accord. There have been calls for international coordination and the Commission is prepared to engage in such efforts, but that does not mean that people should stop the national processes. He does not have a strong preference for any one of the models for separation, but he acknowledges the rationale behind the OECD's suggestions. There are sound reasons for moving ahead with structural reform. This may not be a great place to start, but it is where Europe is at moment.

Spiegel asked Blundell-Wignall about the differences between the OECD's suggestion and Vickers, Volcker and Liikanen.

Blundell-Wignall said that he is not fully in agreement with Liikanen, Volcker or Vickers. Liikanen has many good ideas but it looks at banks with a certain characteristic. This characteristic is the trading of for sale securities. To get flagged for separation under Liikanen, a bank has to have a certain percentage of for sale securities. The OECD finds that this variable is positively related to the distance to default. Liikanen makes other proposals on market making and other issues, but the initial variable is wrong. Instead, derivatives should be the variable. Volcker's also has issues: it implements a blanket ban on speculating on short term price movements, but on the other hand, it also says the bank can do market making. You cannot do market making, originating and underwriting without making a book. Of course, you have to speculate on short-term future price movements when you're making a book. This is an aspect of Volcker he does not understand. Vickers is the closest to the OECD's suggestion. The only problem Blundell-Wignall sees with Vickers is that it would ring-fence the retail bank, but not all the other subsidiaries of the bank. For a big bank like Barclays with subsidiaries in many jurisdictions, creditors could still chase after the subsidiaries' money; they are just not allowed to chase after the parent bank. The OECD proposal would take this one step further.

Deckers reacted to Blundell-Wignall's criticism of Liikanen. The definition of the examination threshold issue was also addressed in the Commission's consultation paper. Certainly, the recommendation to include AFS has been widely criticised. The Commission has put forward a number of alternative suggestions, some of which look at including measures of derivatives exposures. The point about derivatives exposure is well-taken. The Commission's suggestions also include other measures, but derivatives exposure is definitely being taken into account, on both the asset and liability sides.

In response to a question on the balance between financial stability and the lending capacity of the financial sector, **Deckers** acknowledged that there was an issue related to liquidity. The Commission is aware the possibility to make adjustments to CRR/CRD IV. As such, some of the necessary requirements will be gradually phased-in; for example the liquidity coverage ratio (LCR). There are possibilities to tailor the leverage ratio to the different business models of banks. The Commission is not unaware of these issues, they should, however, not hold up the policy implementation process.

Blundell-Wignall said the problem with lending is not unrelated to the structural reform process: separating banks, to leave just the core deposit banks with guaranteed deposits would get lending going tomorrow. However, there is one problem: the forbearance issue. So even if the banks are separated, with these forbearance issues persisting, there is on the demand side. From his experience with the major European banks, the number one problem is too much SME lending to semi-zombie firms that are not allowed to fail for political and economic reasons. The money needs to be taken from zombie companies and handed to young efficient companies. There has to be a 'bad' bank to deal with the troubled assets. The number of 'bad' assets is probably quite large in some countries, but it has to be done.

Spiegel asked whether this is like the 1980s Japan.

Blundell-Wignall said he does hope Europe's situation won't be quite as bad. In Japan, at the time, there were some companies that were completely gone and still had money given to them. The forbearance issue in Europe is slightly different. These companies still can service some of their business. It's a problem of dynamic. The SME lending has to move from the dysfunctional to the functional businesses.

Responding to another question on the leverage ratio **Deckers** said that there is a progress foreseen to include the leverage ratio in CRR at a later stage. There will be a disclosure requirement from 2015. The EBA will report and then the Commission has to come up with a proposal that would be applicable from 2018. The Commission is also, of course, following the consultation process going on in Basel. Europe is applying Basel III to all its banks and has to take into consideration the coherence of the Single Market.

Responding to a question on competition, **Blundell-Wignall** said that the OECD perspective is that if you separate subsidiaries you are breaking monopoly. The implicit guarantee of 'too-big-to-fail' means that people are cross-subsidising risky business. When everything goes bad, there is a socialisation of the losses. When things go well, there is a privatisation of the gain. The fair pricing of risk is very much a competition policy. The treatment of counterparty risk under the Basel process is making a big mistake:

the credit valuation adjustment (CVA) charge. The CVA-charge works on netting pools. The netting pool means that when you have a capital requirement based on a derivatives position, you're offsetting your trades. You may be up some, then down some, but you can just net them off. The CVA-charge applies to that. Netting is a settlement concept that has got nothing to do with market risk. To base the CVA-charge on netted derivatives is a crazy thing to do because the position can change in the course of the same day. What it does in terms of competition is that banks are encouraged to become more concentrated in derivatives trading because the bigger you are, the more concentrated you are, the more possibilities you have for netting. Therefore it works against competition and in favour of concentration. That's a really big problem in the way counterparty risk is being traded.

Session 2 - Derivatives: Do we need a $700 trillion market?

Panellists (from left): Thierry Philipponnat, Secretary General, Finance Watch; Richard Raeburn, Chairman, European Association of Corporate Treasurers; Jennifer Robertson, Deputy Head of Unit, Financial Market Infrastructure, DG MARKT, European Commission; John E. Parsons, Senior Lecturer, Sloan School of Management, MIT; Dennis Kelleher, President and CEO, Better Markets (Moderator)

Dennis Kelleher said that the last crisis was incubated through the risks, spread across the world. With EMIR and Title 7 in place, is the job done? The complex structure of derivatives lets risk be hidden. In whose interest does the derivatives market operate?

John Parsons said that the basic way to describe the debate about the derivatives market is a big fear about the future. Talking about the size of the market, people in the industry complain about the restrictions on the market. They worry that all the regulation will reduce the amount of trading conducted. Would less trade be a bad thing? He cannot sympathise with this kind of fear. He is in favour of an active, well-regulated derivatives market.

The question is therefore not how much derivatives trading there is, but how it is regulated. If trade is well managed and run in the right way, then the trade will to support the economy broadly. The market needs to be structured in a way that means companies understand the risk they are taking. The right amount of securities needs to be involved. Regulation needs to be transparent. In the US, derivatives and futures markets have a long history. The original futures markets in the US operated the same way the OTC swaps market functioned: no requirement for clearing and no requirement for margin. At the turn of the last century, central counterparty clearing was a big innovation; one that regulators are now trying to bring back. The biggest derivatives markets fought this mandate for a long time. Now, the CME was founded in the early 1900s with central counterparty clearing and mandatory margins as a part of its operating principles from the start. From the 1920s, through until the 1970s, exchanges operated with the restrictions the G20 is now trying to re-impose on the markets. Nobody complained about central counterparty clearing or margin requirements impeding the real economy. It was only in the late 20th, when there was a loophole for swaps, that these rules were undermined. Now, we have to ask how we want to regulate the securities markets. There was a clear consensus on this issue. On derivatives regulation, the Pittsburgh G20 was very clear. One of the reasons why this was so clear is that it is what used to be there. It is proven to work. Derivatives regulation has to go back to what it was.

Jennifer Robertson said that three issues were highlighted by the crisis:

Firstly, insufficient management of operational risk, secondly, insufficient management of counterparty risk and thirdly, a lack of transparency. Some aspects of the business just stayed out of sight of the regulators. This is being addressed now. Now, the regulators are trying to get a clearer picture of what's going on. Regulators dealt with these problems differently. There were lots international conferences discussing what kind of derivatives market is desirable. These debates boiled down to two main goals: the derivatives market has to become safer and more efficient. To make markets safer and more resilient, the obligation for central clearing was introduced, a powerful tool for managing and reducing risk. Its benefits were recognised at Pittsburgh which introduced the obligation for all standardised OTC derivatives contracts to be traded on exchanges or electronic trading platforms and cleared through CCPs. This clearing obligation was implemented in Art. 4 of EMIR.

Secondly, because not all contracts will necessarily be eligible for centralised clearing, these trades will not be cleared and they will have to be managed bilaterally. They still have risks. This is why EMIR introduced requirements for financials above a certain threshold to measure, monitor and mitigate the risks through operational processes, such as electronic confirmation. There are further requirements on non-centrally cleared trades to make sure they are appropriately collateralised through the posting of margins. The second objective of making markets more efficient is achieved in various ways: firstly, it requires more pricing transparency. This is one of the main objectives of MiFID 2, which will impose an obligation to trade OTC derivatives on organised trading venues. This was another G20 commitment. Secondly, efficient supervision of the market has to be ensured. This will be delivered through trade depositories which provide regulators with detailed information on the markets. The first step is to collect this information and make sure it is available to regulators. EMIR rules that all firms and contracts should be recorded. Probably more importantly, regulators have to learn how to manage this information. EMIR gives regulators access to information on depositories. Supervisors will then have to analyse this information and develop risk management models. This will be a learning curve for supervisors.

Finally, derivatives markets are global and will need a global solution. International principles by the Basel Committee and CPSS/IOSCO help, but in the EU third country regimes deal with the interlinkage. The Commission can make provisions for the equivalence of the legal, supervisory and enforcement frameworks in third countries. If equivalence is granted, it provides deference to the rules of foreign jurisdictions with regard to CCPs, trade repositories, reporting, clearing, margins and risk mitigation techniques. This important element to make sure that there is no space for regulatory arbitrage. If international regulators fail to deliver regulatory consistency, they risk undermining the regulatory reform they wrote.

As far as the size of the markets is concerned, Robertson acknowledged that derivatives markets have expanded a great deal in the last 15 years. This growth has been concentrated in the OTC markets, which have multiplied in size by 10 between 1988 and 2008. However, there has been a relative decline in size since the crisis. The relative role of derivatives in the global economy has also changed. Comparing the derivatives markets to global GDP, derivatives markets were three times global GDP in 1988. In 2008, they were 13 times that and in 2012 nearly ten times global GDP. This shows that the global economy relies more heavily on derivatives than before. Global derivatives have two functions: firstly, to transfer risk between economic agents, but secondly they also play a role in investment and portfolio diversification. They do not create additional value, but redistribute it between market participants. In a well-functioning market, these risks should be borne by those who can best manage them.

How should regulation work? For the Commission, the most important point is that, despite the risk management investment functions that markets can perform, the underlying problems (operational risk, counterparty risk, lack of transparency) can make these markets sub-optimal and can pose real risks for the global economy at large.

How efficient are the reformed markets now? - Robertson pointed out that many of the agreed reforms are still under way. Centralised clearing is underway in the EU. CCPs are applying for authorisation and recognition. ESMA is taking care of this process. This is a pre-requisite of mandatory clearing. These CCPs need to be adequately prepared and as safe as possible before all those contracts are sent their way. Once this is done, ESMA will decide which classes of derivatives will be subject to clearing and when. Therefore, it will probably be mid-next year before the clearing will actually click in.

In other areas, EMIR is already partly in place: the enhanced risk reporting requirements. Other works on margining requirements are still under way, as are many of the provisions introduced under MiFID. MiFID is still subject of negotiations between Parliament and Council. The derivatives market reforms have to be implemented vigilantly. The reforms have to be fully implemented on national, EU and global level. From the crisis, we know that market infrastructure is very important. With this in mind, a lot of risk is put into CCPs. High prudential and risk management requirements are there to make sure that these CCPs are up to the test. Nevertheless, there have to be recovery and resolution principles for CCPs in future. This is one of the areas in which the Commission will come forward with proposals in the next year.

Richard Raeburn said that financial trade associations, politicians or consultants are not best placed to say how the real economy works. It is important to keep in mind that financial regulation always has a strong real economy impact. He does not agree with Warren Buffet's statement that derivatives are "weapons of mass destruction" he thinks they have a purpose. This is a demonisation of derivatives. He thinks some derivatives are a very good thing. The debate needs to exceed mere demonisation. The real economy doesn't speculate with derivatives; it needs derivatives to eliminate risk. He admits that there are a few rogue traders, but they usually get found out and fired. That is not the general model.

The general model is that derivatives serve their crucial purpose: to mitigate risk. He said that roughly 5 per cent of outstanding derivatives trades are actual end-user, non-financial counterparty transactions. If these did not exist, or if companies felt they couldn't enter into them, given the conditions under which they can use derivatives, and then there would be much more volatility in the real economy. There would be setbacks to employment and to growth. Regulatory and political objectives should be based on stimulating and sustaining the real economy. Everybody has a commitment to eliminate volatility in the real economy.

He does not think the crisis was about derivatives. Yes, there was AIG, but that was a failure of regulation. But mainly, the crisis was a failure of risk management in banks. It was a discovery that banks did not know how to manage and price risk. It was a failure of compensation policy that led to motivation being on short term results, which were not in the interests of the wider stakeholders. Of course, it was also a crisis of bank resolution. Neither Europe, nor other jurisdictions have tackled the issue of too-big-to-fail successfully, so far.

Thierry Philipponnat said that there are two big topics today: the first question is whether existing derivatives regulation a plus or a minus for the real economy. Everybody agrees that finance should not be the objective but be the means of financing the real economy. The second question is whether we need a $700trn derivatives market at all.

There is a big debate about whether the size of the derivatives market is meaningful at all. Many say that the size is not the right measure. He explained that the size of the derivatives market is measured by estimating the underlying notional value of outstanding derivatives. That is the underlying notional amount of financial assets controlled by the derivatives. Ten times the world's GDP is controlled by derivatives. That $700trn figure is not a measure of the risk. The industry often says that the right measure is the gross market value of derivatives. The gross market value of derivatives is just the sum of the absolute value of all the derivatives outstanding in the world. Roughly 80 per cent of derivatives outstanding are swaps. Because of their nature, the gross market value of swaps is prized at zero. This means that 80 per cent of this large market is meaningless. The present gross market value is $23trn, that's 3.6 per cent of the outstanding notional. If you take the net measure, which Blundell-Wignall considered as being the wrong measure, then this goes down to 0.5 of notional.

Many people say that the size of the market has decreased because the gross-market value has declined. This is not correct. If the gross market value declines that means that the volatility in the market has gone down, so the derivatives are worth less in mark-to-market measure. This does not mean that its size has decreased. The official Bank for International Settlements figures show that it is still growing. There is a market that's already ten times the size it was 20 years ago. Between 5 and 8 per cent of this market are dealt between banks and non-financial corporation.

There is a constant argument that derivatives are necessary for hedging. Philipponnat does not dispute this. There is no doubt that derivatives are very good hedging tools, but if only 5 or 8 per cent are used for hedging, what is the rest used for? And how did companies in 1988 manage their risks in 1988, when the market was ten times smaller? The market managed fine back then. Derivatives are derived from the real economy. So, since then the derivative market has grown 540 per cent, bond markets have grown 140 per cent and equity markets have grown 35 per cent. Is that still hedging? Is it still serving a purpose? Sheila Bair, in her book, says that there should be a regulation for the specific case of credit default swaps that would link the fact that you hold credit default swaps to an insurable economic substance. If you are hedging, there should be a link between the use of derivative and the use of the underlying.

Why is there a situation where one market is growing so much and what is the consequence of this? The answer is that the too-big-to-fail subsidy is feeding this market. The derivatives market is made up of G-SiFis. They benefit from the public support. They can re-finance their derivatives book at a level that is artificially low and that artificially feeds the growth of this market. Without too-big-to-fail, traders would not be able to borrow at such low levels and many derivatives traders' behaviour would not be tenable. The exponential, unlimited growth of the derivatives market is fed by the too-big-to-fail syndrome. This is why Finance Watch links this issue to the issue of reforming banks. Without addressing too-big-to-fail the derivatives market will continue to grow.

The biggest problem is that derivatives trading is the major source of interconnectedness between the banks. Interconnectedness creates the fragility that we see in the banking sector. Therefore, until the issue of too-big-to-fail has been tackled, markets will continue to remain fragile. He questioned whether the derivatives market as it is still serves the real economy.

Kelleher reiterated that only 5 to 7 per cent of the market still serves the end users. This raises a fundamental question: if the market serves the purpose of hedging the real economy, why does a large majority of the market not actually deliver on this promise? How can regulators accommodate for the challenges of the future?

Parsons said the differentiation between real economy and non-real economy is often misused because some people try to hide under the label of 'non-finance'. Derivatives are abused as often by 'non-financials' as by 'financials'. A lot of financial companies can sensibly use derivatives. Insurances and mutual funds use them to monitor the volatile flows into the fund. Therefore, it must not be assumed that 'non-financials' are a homogenous force for good. The balance sheets of the banks are what customer is looking for. But the banks' balance sheet is essentially the sovereign's balance sheet. Primarily financial institutions benefitted from this. Trading by hedge funds involves taking large risks. Risk needs to be priced correctly.

Robertson said that under EMIR, non-financial corporations are included. However, there are safeguards to make sure that only the largest companies are caught in the regulation. There is a phased-in approach to EMIR. The working group on margin requirements has been considering carefully getting the balance between regulating the companies and the impact on liquidity. Getting this balance right is difficult. Successful regulation in the future will need vigilant national, European and global supervisors. There must not be any loopholes in the regulation, which would benefit the shadow banking system. One case where this is very important is the special purpose vehicles to circumvent EMIR.

Raeburn said that the real issue is whether the corporate use of derivatives has grown anything like the percentage of the overall derivatives market. Corporates are simply using derivatives the same way they have always done. Therefore, the exponential growth that was observed in the market is nothing to do with the corporates. On the question why it has happened nevertheless, he said that there are two entirely different markets. The reason those 80 per cent of the market are what they are that capital was under-priced and traders went to town. This is nothing to do with the real economy. Where it becomes a serious issue is when regulation is driven by what happened in the financial sector and does not take full account of what it does to the real economy. The original proposal for EMIR asked the real economy to give up managing credit risk and to take up liquidity risk. This was a huge error in the loose G20 statement declaring that all derivatives should go into clearing. Companies do not have access to central banks. The do not have unlimited funds. Forcing companies to exchange trade and collateralise their transactions, would have drained a huge amount of funding from the real economy. That is why he insists that the exemptions under EMIR and the caveat under Dodd-Frank are entirely right. What you don't want to do is to penalise the real economy by forcing it to take on a risk that it inherently cannot manage.

Kelleher said that if the real economy somewhat overlaps with the end-users group of the derivatives market, wouldn't be much of a burden, given the multiple provisions for end users under Title 7 of Dodd Frank and now contemplated under EMIR. More problematic is the number of non-end users that pretended to be end-users asking for an exception for non-end users. The debate on derivatives regulation was dominated by end-users, some of which were financiers in disguise.

Raeburn said that was not accurate. Dodd Frank and EMIR got it right in capturing the energy companies with trading wings. This is not what he is defending. He is defended the real economy's use of derivatives to mitigate risk.

Kelleher asked which two things Philipponnat would write into EMIR if he could.

Philipponnat said that this issue relates to the question of democratising the reform process. In Europe, EMIR said CDS must be related to insurance risk. This was put into law, but when the implementation is discussed there is the whole lobbying machine. In the end, it was decided on a correlation of 70 per cent. Correlation is the most unstable value and there is a 70 per cent of correlation between almost any event with any other. The debate about implementation undermined what was a good text to start with. The whole initial democratic process was emptied by post-fact lobbying. He thinks that it is a stretch to claim that no corporate ever speculates on derivatives. There are plenty of examples to prove otherwise. The exemptions on non-financial clearing included in EMIR make it difficult to argue that the users of derivatives do nothing but hedging. It seems to him, that the US have been somewhat stricter guarding the implementation process.

A question from the floor highlighted that there are very few players dominating the derivatives market. Do the reforms that are being implemented now address this problem? A further question addressed the expansion of the market, was it caused by the financial sector or the financial departments of the big corporates?

Robertson said that DG COMP follows the phenomenon of cartel behaviour in the derivatives industry. If there is there evidence of cartels, the Commission will look into it.

Parsons said a lot of real economy companies that do a lot of 'banking business'; oil companies, for example. Many of these companies run speculative derivatives operations. He does not want to exaggerate the significance of these occurrences. They are not the reason for the exponential growth in the sector. Lots of real economy companies serve captive financial institutions. That is not necessarily a bad thing. There are also car manufacturers that sell insurance. It's not necessarily bad for an agricultural company to offer derivatives as a service to customers. What's important, even though this phenomenon is not too big at the moment, is to have a regulatory framework in place that deals with all companies the same. The issue must be whether a company is dealing with derivatives and whether it is doing so safely. As long as regulation treats all companies the same, it shouldn't matter whether a derivative dealership is housed by a financial or non-financial companies.

Raeburn said that when an oil company chooses to have a trading room, these don't get exempted from regulation, and they shouldn't be. They are irrelevant to the real economy. IFRS; no real-economy company with any sense would speculate on derivatives. They should not be called financial company.

Philipponnat responded that micro-hedging is possible and still going on. Macro-hedging, however, is an illusion. It is not possible. You cannot eliminate risk from the system all together. He does not think the cartel structure in the derivatives market has been sufficiently addressed. Responding to a question the size and complexity of the market

Parsons said that the market is not as complex as people are led to believe. The complexities are minor variations in details which can be handled through basis trades. The complexity is the tool of the cartel to maintain the market as dark as possible. He would like to see EMIR implemented more speedily. All US derivatives now report to trade repositories but no one knows how to read that data. This reform has to be implemented seriously and quickly to implement standardisation.

Session 3 - Purpose: A financial system to serve society

Sheila Bair (Chair, Systemic Risk Council; former FDIC Chair) said that she is proud of the work the FDIC did. It was a difficult and challenging time she spent at the FDIC. There was relentless media scepticism about whether the FDIC had the funds to protect the trillions of dollars' worth of deposits in the US banking system. She admitted that, leading up to the crisis, some mistakes were made that should not have been made. The response to the crisis could also have been better given better legal tools to deal with failing banks. The financial services industry is supposed to serve the credit needs of the real economy, not the other way around.

However, she thinks there can be no financial services industry serving the real economy, so long as the industry is populated with 'too-big-to-fail' institutions. The two are not compatible. 'Too-big-to-fail' is an issue of market perception related to interconnectedness. This means institutions are so interconnected that the Government will step in to protect their creditors and shareholders rather than let the institution fail. This is a bad idea because it leads to a loss of market discipline. It encourages people to deal with these 'too-big-to-fail' banks thinking that they are safe. This gives them very advantageous cost in their funding structure and gives them incentive to use a lot of debt. In consequence, this makes the system much more unstable. The 'too-big-to-fail' perception has been persisting for a long time in the US; it became explicit with Fannie Mae and Freddie Mac. The credit rating agencies also explicitly gave the largest banks bump-ups in their credit rating, based on the idea that the Government would come in and help them if they got into trouble. Of course, this was ratified in 2008 and 2009 with very generous bail-outs.

Prior to the crisis there were not the kinds of robust and clear tools to tell the public and the markets that there will not be any bail-outs. This is not to say that there will be no more interventions when a financial institution is failing, but when there is intervention, the protection of the continuation of financial services has to be the overarching priority. The people, the businesses, and the consumers who are relying on the financial institution have to come first. By their very nature, financial institutions fall apart if you take away the funding. This causes disruption in the market, which needs to be avoided. This is one of the problems with traditional bankruptcy. You cannot usually get this funding in place fast enough, especially not with a financial institution that does not have as much transparency as it should in terms of the quality of its balance sheet. This is what happened with Lehman Brothers.

The FDIC has always had a special bankruptcy process for failed banks. This is not a bail-out process, but a punitive process: shareholders are wiped out, the unsecured creditors are haircut and uninsured depositors frequently take losses too, consistent with the FDIC's 'Least Cost Test'. What the FDIC can do, however, and has always been able to do through the Failed Bank Resolution, is to provide liquidity support. Liquidity support has to be provided to protect people's mortgages, wages and businesses. Intervention needs to insure credit flows to the real economy, but those who invested in this institution, the shareholders and the creditors, must not be bailed out. So while there are good reasons to provide liquidity support, there must not be a protection for the shareholders and creditors of the institution.

What is not justified intervention is an intervention because of interconnectedness. The idea is that a bank has to be bailed out because failing to do so would lead to other banks' failure. A situation like that is not forgivable. The regulators have the tools to expose these credit exposure relationships, and they have had these tools since before the crisis. As part of their 'living will' to the regulator, G-SiFis have to declare their credit exposure to each other. The Fed, who is the supervisor for these institutions, has to limit these exposures. They put out a very aggressive proposal a few years ago to put limits on these inter-relationships. Unfortunately, these rules have not been finalised as they ran into serious resistance by the industry, but Bair considers them necessary.

Even more dangerous is political interconnectedness. This fed into the public dissatisfaction and cynicism that resulted from the bail-outs in 2008 and 2009. Some banks were getting breaks that others weren't for one reasons or another. That is bad from a market standpoint, bad from a political stability perspective and atrocious from an ethical standpoint. This is important to remember as Europe considers how to structure its own SRM. The authority that will have the resolution authority will have to be very well insulation from any kind of political pressure because that can infiltrate decision making and it should not.

Bair moved on to review why 'too-big-to-fail' is wrong. It is wrong for four reasons.

- Firstly, it is unfair because small investors do not have this special backstop. The injustice makes people angry, and rightly so: it is dramatically inconsistent with a market-based democratic system. This leads to political instability.
- Secondly, it is bad economics because it makes the financial sector too big and encourages financial institutions to be even bigger.
- Thirdly, it hurts innovation because it disadvantages smaller competitors. This is skewing resource allocation. It also makes smaller banks less competitive. Large institutions mustn't have that kind of benefit.
- Finally, it messes with the market's in-built corrective mechanism. In the US, the banks weren't forced to hold a lot more capital through the stress-testing process. They were bailed out but not forced to clean up their balance sheet. They have many years to reach those capital requirements. This interfered with the markets natural corrective mechanism. Sick banks don't do a lot of new lending. They are busy nursing their balance sheets, playing it safe on cheap deposits and government securities or GSE securities. They will nurse themselves back to health. This means that they will not go out and make small business loans or anything else that has a significant risk. Another aspect is that this reinforces bad management and unsustainable business models. The market's natural corrective mechanism would address this by letting these institutions fail or reallocating resources to managers that are doing a better job and business models that are serving real economic needs. The bail-outs of 2009 were a mistake. They stabilised the system but impeded the natural corrective mechanism. Had banks been forced to reform dysfunctional operating systems, there would have been a stronger recovery.

While 'too-big-to-fail' has to eradicated, it also needs to be recognised that financial institutions are a bit different in the kind of services they provide. So while there should not be bail-outs, there should be intervention with liquidity support to make sure that the credit flows keep going. With insured banks, the FDIC has always had the authority to provide temporary liquidity, but it did not have this authority with regard to non-bank financial entities during the crisis. For the activities outside of an insured bank, if you didn't have another kind of intervention, bankruptcy was the only solution. Lehman Brothers showed that bankruptcy does not work well. The way derivatives are treated in bankruptcy is another problem that can make a traditional bankruptcy highly disruptive. One thing that the resolution authority can do is to provide continuity funding so that there is not this disruption for the franchise. Another option is advance planning. The FDIC has staff in the very large banks, in addition to having a planning process through 'living wills' and resolution planning. This means that there is a continued presence of the resolution authority in these large institutions.

Another tool that a government-appointed resolution authority has is to work with other regulators. This is helpful because one of the biggest challenges in resolving these very large financial conglomerates is to figure out what to do with the overseas operations. Hopefully, there will soon be better global agreements on resolution authorities and mechanisms. In the interim, the FDIC has to enter into bilateral recognition agreements with other countries to recognise processes and authorities. It has to be ensured that there is no disruptive ringfencing with regard to the overseas operations, which can be bad for everybody: the US franchise as much as the foreign subsidiary.

It is important to understand that, in Dodd-Frank, there is a flat-out ban on bail-outs, so the FDIC strictly only provide liquidity support. It cannot provide any support to shareholders. Unsecured creditors and bondholders have to be dealt with in the same kind of claims process that would apply to a basic bankruptcy process. Much effort was put into getting this legally hard-wired in Dodd Frank. There are only two places where you can differentiate among creditors. One is to continue essential operations. If you want to keep the franchise going you need to pay employees and providers of essential services. In that respect, it can aid recovery to differentiate between creditors. Often, failing banks have offered to pay a premium, in order to keep the uninsured depositors un-haircut. In some cases, the premium offered more than compensated the FDIC for covering the uninsured depositors. That is appropriate. There is a similar principle in bankruptcy. By differentiating between creditors, you maximise your recoveries.

However, Dodd-Frank is very hard-wired and very punitive towards shareholders and creditors. It is also hard-wired against boards and executives. They lose their jobs. This is just the same as it would be for a small bank. Bair stressed that this kind of bankruptcy is tougher on paper and she thinks that is appropriate. If there had been a Title 2 process in early 2008, Lehman would not have happened and Bear Stearns would not have had a bailout. Market discipline would have been in place. These are the benefits of a hard-wired and clearly harsh process for people who have made mistakes. They are responsible and will be held accountable.

Bair stressed that, in her opinion the FDIC is perfectly equipped to protect the taxpayer and the industry. It now has better tools and structures. These cases are always messy and there is still a lot of work left to do to get the system working as it should, but even now the FDIC is up to the job. This is because of the Single Point of Entry procedure. In the US, large conglomerates are mostly funded from the top of the house. They have a holding company that owns everything else underneath. Publicly traded equity and debt are issues through this holding company, and then the funds are funnelled down into the subsidiaries. Right now, there is a lot of equity at holding company level. That is all available for loss absorption. This way, necessary institutions like the mortgage subsidiary can kept open and operating, while any losses associated with the resolution will be absorbed by the shareholders and the creditors. This is appropriate.

Two things need to be done to ensure this system functions as well as it should. One is that the market is starting to figure out that this will be the FDIC strategy. This means that there is already a lot of gaming going on. One of the disadvantages of the strategy is that, if you are a funder at the subsidiary level, you will look to invest in a subsidiary, rather than the holding company. To avoid gaming like this, the Fed has announced to have a minimum long-term debt requirement at the holding company level, to make sure that there is plenty of loss absorption capacity at the holding company level. This will also move the focus of funding from short- to long-term. The US financial industry has about 13 per cent of non-risk-weighted assets. Bair considers this to be too low, but is pleased that there is at least recognition that there should be some sort of a minimum requirement here. She expects the Fed to move on this very shortly. The market also has to understand that this is not the only thing that’s available for loss absorption. Short term debt should also be, and is, available for loss absorption. The problem with short term debt is that it will run before the bank actually fails. Banks don’t fail overnight. Lehman was a slow burner for months, although, in this case, short term debt did not run because everyone was convinced there would be a bailout. To make sure that, by the time the place fails, there is still a good stack of unsecured debt that can absorb losses or be converted into equity, it is important to have debt with a minimum duration of a year.

Another thing needs to be done. The FDIC and Bank of England just sent a letter to the International Securities and Derivatives Association (ISDA) asking to change documentation for swap instruments, so that swaps no longer have an automatic right to terminate if a G-SiFi goes into resolution. That’s important because, at the moment, US law says that if it’s a US counterparty they cannot terminate.

Dodd Frank is specific on this. The FDIC receiver has not got very much time to tell counterparties whether they are going to accept their contracts or not. If they accept the contracts, the derivatives counterparties have to continue to perform on these contracts. In the bankruptcy process, this is not the rule. For foreign counterparties, who are not subject to US law, there is still a fear that they could terminate the contracts and walk away, which would cause disruption. ISDA has the tools to fix this by changing their contract documentation. This debate has been going on for too long already. This is one thing the industry could do to make sure the resolution progress works as well as they should.

Over the long-term, these institutions have to be simplified. Bair is in favour of ring-fencing. The single-point of entry system is the only viable option in the short term - at least for US banks with their huge tangle of legal entities. Longer term, the regulators need to get them to simplify their legal structures, reduce the number of legal entities and align them. Right now, institutions are so tangled and interconnected that it is very difficult to efficiently resolve. There also needs to be international subsidiarisation. So if there is a very large operation in a foreign jurisdiction, European regulators should be able to tell American banks to subsidiarise and the other way round. That would make for a more stable system and ensure capital liquidity in each jurisdiction. It would also mitigate the contagion risk that was seen during the crisis. Simplification and subsidiarisation over long-term would give regulators more options in terms of resolution and would make international operations much more settleable when they get into trouble. An added benefit of doing that, particularly if it was disclosed publicly, would be that shareholders would have a better idea whether these large legal entities are actually offering good shareholder value.

Right now, the complex legal structures act like a poison pill. Some shareholders would looking at their unsatisfactory returns, thinking that maybe this huge conglomerate would be better off split into its constituent parts. Right now, the legal structure of these institutions stifles any such thought at the beginning. There once was a shareholder request to see what Citi Group would look like broken up, and the SEC staff gave them a no-action letter which meant that they didn't have to put this request on their proxy. She thinks that was unfortunate; this is really what shareholder proxies should be doing.

However, there has been some very interesting analysis on this phenomenon by Mike Mayo and others. Mayo looked at the 50 largest banking organisations in the US over the past ten years and how they performed. He found that the three largest financial services providers (Bank of America, Citi Group and JP Morgan Chase) performed far more poorly than the rest. They had the worst stock returns. They had the worst return on equity and assets. They had the worst revenue. They had the worst efficiency ratios. And they had the worst volatility. Where they did better than every other bank was in compensation.

There is a real issue of management inefficiency in such complex institutions. If shareholders are receiving better information, they are empowered. And when shareholders are convinced that that there is no more 'too-big-to-fail' and no more implied government guarantee, there will be some really meaningful changes. Market dynamic will make them smaller, simpler or even break them up. Having a credible resolution mechanism in place can also help to convince the markets that 'too-big-to-fail' is over.

Based on her (US) experience, she thinks that in the development of the European single resolution authority, the following priorities should be set. The first priority is to hard-wire against bailouts. There is always a lot of political and social pressure to bail-out. Putting banks into receivership and cleaning them up is hard work but it's what's needed. There has to be a claims priority in statute. If receivers are required to minimise losses, then the FDIC is legally unable to give in to the pressure to bail out. To get the maximum benefit from a single resolution mechanism, it has to be fully hard-wired against bail-out. There also needs to be political insulation. The FDIC is an independent agency; this helped to protect it against political influence. Consistent with that, the resolution authority needs to have the autonomy to make decisions. You also need a nimble resolution mechanism to ensure the good parts of the bank continue to keep credit flowing to customers. The rules need to be well defined and hard-wired, but beyond that the authority needs to have agility to act independently. Advance planning is key for the quickest possible reaction. Good information, directly from the banks can help supervisors to act in time.

The authority has to have the ability to go into banks, interact with them and get information directly from them. This is essential.

David Shirreff (The Economist) asked whether the resolution structures in Europe should be in action before other parts of the structural issues are tackled.

Bair said that it is possible to use parallel track to get resolution and structural reform into place. She thinks that the structural reforms proposed so far are very much complimentary of the resolution mechanism, so can be worked on simultaneously.

Shirreff asked whether resolution will always be a mess.

Bair replied that resolution always is. Nobody says it will be easy once a G-SiFi is concerned, but it can be done and it will be done.

Shirreff asked whether the demand for subsiarisation spells the end of globalisation as investment banking knows it?

Bair said that this is not necessarily the case. Investment bankers would love to be not subsidiarised and move capital and liquidity around to wherever they need it. That is cheaper for them. However, when there is a global meltdown, capital is needed everywhere and then these banks don't have enough of it. Subsidiarisation makes the system more expensive, yes, but there are some banks are doing it already and they seem to be able to make good profit.

Shireff asked whether the Single Point of Entry system is the way to go.

Bair replied that right now, Single Point of Entry is the only way to go. Long term, she does not think it is the optimal way to go. Now, it is the only feasible way. Over time, financial institutions should be forced to simplify. This would give more options for resolution. You could, for example only put the investment bank under Title 2. The derivatives treatment in bankruptcy is still a problem, but over time, this is what regulators should be looking to do.

Shirreff asked whether Lehman Brothers was a necessary lesson.

Bair said that Lehman underscored just how fragile the interconnected banking system is. Maybe it did wake up regulators and teach the industry a lesson.

A question from the floor asked how good banking can be incentivised. How can risk premiums be used to prevent moral hazard?

Bair said that when she joined in 2006, the FDIC had just got the authority to adjust deposit insurance premium based on risk. The initial system that was put in place then didn't differentiate enough. Unfortunately there no time to revise it until after the crisis. It was then changed very significantly just before she left. One thing that was important was to give significant premium penalties for those who rely on uncollateralised borrowing to fund themselves. That made the institutions less resilient and the resolution more expensive. A pre-funded resolution fund, able to charge based on the assessment of risk can be a very good tool. She understands this is also being discussed for the Single Resolution Mechanism.

Another question asked Bair's opinion about increasing the leverage ratio. The French and German authorities are refusing to increase this ratio. What are their motivations?

Another question addressed the subject of the systemic risk posed by tax and prudential havens.

Bair said that the banks in the US are still over-levered. The situation is even worse here. She wishes the French and German Governments would think of the benefit their taxpayers. Every dollar of equity that is held in the banks, would protect their taxpayers from potential losses. In the US, the bail-outs made money on a cash flow basis, not a subsidy basis. In Germany, taxpayers have had to contribute to bail-outs. There is a direct trade-off: the thicker the equity cushion, the less likely banks will fail. Or, if they do fail, there is going to be plenty of material for loss absorption protecting innocent bystanders. In addition, if banks are allowed to operate with that level of leverage, then 'too-big-to-fail' is effectively being re-endorsed. No investor in their right mind will buy the debt of these large banks unless they think there is an implicit government guarantee. There are tradeoffs to be made. The idea that it is going to hurt lending has been debunked. Better capitalised banks do a better job at lending. There is data to prove this. Mervyn King and others have spoken about it. The better capitalised banks are doing a better job at lending in bad times. In response to a question on tax havens, Bair said that this question is also related to the leverage ratio. The way bank regulator risk-weighted assets absolutely created this mentality. Firstly, banks were allowed to use their internal models to say how risky their assets are, which impacted how much capital they had to have. Banks were given incentives to start using their models to game how much capital they had to hold. Even standardised risk weights should have better thought through. Collateralised debt obligations (CDOs) are an example of such errors. If you had a CDO, wrapped in credit default protection underwritten by someone like AIG, that had zero risk. Repos are another such example: you still can use 100 per cent leverage on repos.

A question from the floor asked why the credit rating agencies (CRAs) are still rating those big institutions differently.

Bair thinks this is a mistake. The CRAs have now reduced some of their bump up, but they are still sceptical as to whether the regulator will actually do it. Actually, they are more worried about the political pressure from Congress. She does not think this is a danger. She does not want to see one of the G-SiFis fail, but she does think that if one was to fail, the tools for resolution would be there.

Shirreff pointed out that in the eurozone the risk-weighting of sovereign bonds is very forgiving.

Bair said that this is a problem. There is a larger discussion to be had about fiscal consolidation. If you had a leverage ratio, some of the incentives on sovereign debt would not be there because the leverage ratio is not sensitive. Right now, there is every incentive to load up on assets that are really not safe at all. Responding to a question on the SSM, Bair said that the FDIC relies on primary supervisors to know whether a bank is insolvent or will soon be insolvent, but there has always been a back-up authority to make this decision independently from the primary supervisor. If the primary supervisor wasn't doing its job, there were other ways. This is important. The ECB is a top notch organisation, and from what she understands the supervisory board will be separate from the monetary policy section. Nonetheless, in her experience, admitting that a bank is in trouble is not something that comes easily to a regulator whose primary job it was to supervise the bank. Sometimes, therefore, they are not as quick as they should be to acknowledge these problems. Having another authority with ability to disagree is a disciplinary tool. With the FDIC, this was only the case once. Just knowing that there is a second authority kept the primary regulator on its toes. Whether the SRM will have the authority or not, the ECB should have the metrics to work out what the trigger for resolution should be. If there is increasingly aggressive supervisory intervention, at some point it may just be time to pull the plug. An established system to trigger this should be as objective as possible in its judgement. That would help the ECB too. Again, supervisory authorities can be susceptible to political pressure. Having the system as hardwiring it against political influence is also important. Responding to a question on the holding company structure, Bair said that there is risk of double leverage. If there is a highly-leveraged holding company issuing a lot of debt, taking the proceeds to buy equity shares in the bank, the bank is reporting a really high capital ratio, but really levered money coming from the holding company. The focus should therefore be on the consolidated equity situation. You cannot only look at the operating subsidiaries. In the US, holding companies are a fact of life that is not going to go away any time soon but it has to be ensured that there is a thick equity cushion and long-term debt which can be converted into equity to recapitalise a new, healthier bank. What concerns her is that US regulators have moved to increase the leverage ratio required by Basel III, which has a bigger denominator than US gap assets. US regulators are recommending 6 per cent for insured banks and 5 per cent for consolidated capital. This concerns her because if primary reliance is on strong capital at the bank level, there will be losses and everything collapses back into the bank. It is therefore important that there is real common equity at the holding company level.

Shirreff pointed out that the Non-Operating Holding Company structure offers a solution to this.

Bair said that she is in favour of this suggestion. In response to a question whether the lack of trust will impact on the resolution and reform plans in Europe, Bair said that the resolution statute itself needs to be hard-wired to give markets cause for confidence. The importance of this cannot be overstated. A fuzzy lined resolution concept could make things worse.

A question from the floor pointed out that the US has a more harmonised banking market and solvency regime.

Bair acknowledged that the harmonised US banking system has made her work easier, but continued to say that this is why Banking Union is so important in the EU. Local thinking does not work for Europe. That will require surrendering some sovereignty. As Mervyn King said, “they operate internationally, but fail locally.” - There needs to be a common framework with the same rules for everybody. This will require some of the individual nations to give up some of their sovereignty and some of their prerogatives in favour of banking union.

Session 4 - Accountability: Democratising the reform process

Panellists (from left): Robert Kuttner, The American Prospect (Moderator); Sharon Bowles, MEP, Chair of the European Parliament's ECON Committee; Robert Jenkins, former member of the Bank of England's Financial Policy Committee; Professor Walter Mattli, Executive Director, Department of Politics and International Relations, Oxford University; Simon Lewis, CEO, AFME

Robert Kuttner said that despite many changes to supervision and resolution, the financial system itself has not changed fundamentally. Although higher capital standards made a difference, there is still a long way to go. Why is the story of reform after this recent crash so much different than it was after the 1930 crash?

Simon Lewis said that reform matters for the legitimacy of the financial sector. Basel III completely changed the scene. There has been significant progress on the key reforms on global level. There is a regular assessment of the implementation process from the Financial Stability Board (FSB). The latest one, released in September 2013, contains a letter from Governor Carney which says that the key reforms are well advanced on global level. Much of the work on the rules is complete, but at national and regional level, there is still some way to go. This makes the case for resolution, shadow banking and derivatives. The industry has to de-risk and change its business model. The process has been long and painful, but already the system is much safer than it was five years ago. There is still a huge amount of work required to regain the public's trust. Basel III was the single most important element of regulatory response to the crisis. In Pittsburgh, there was a mandate which was handed down to the Basel Committee. In Europe, this was taken up in the CRD IV text. This is largely finalised but many of the implementing measures are still being discussed by the EBA. There is some national discretion in the implementation. The main elements will come into force in January next year.

There are multiple levels of decision making. The G20 is a global, political forum which meets irregularly. The Basel Committee is a technical body with a global mandate. It comprises senior, unelected officials from the central banks and treasuries of the world's largest economies. The EU has both political and technical bodies to supervise the procedure. So far, so complicated. However, imperfect decision-making structures lead to a lack of consistency or compliance in enforcement. Some countries are yet to implement Basel III. Governor Mark Carney named and shamed Indonesia in the public letter in September.

However, even in the implementation process, there are large national discrepancies: Switzerland has stricter capital rules for domestic banks. The US has imposed standalone capital and liquidity rules on foreign banks in its jurisdiction. The UK Government implemented the ringfence suggested by John Vickers and the EU is looking at Liikanen. Is this democratising the reform process or is this democracy getting too involved? It is the industry's view that there are widely different standards which could increase costs and present serious operational challenges. However, the Basel model provides interesting safeguards and attempting to prevent countries from engaging in a race to the bottom. The Basel process exemplifies the key tensions among reformers. The fundamental tension is between the desire for strong, effective global rules and the reasonable demand by governments and citizens for diversity, safety and control at national level. This challenge will remain for the coming years.

Professor Walter Mattli asked what lessons can the history of regulation can teach. Reform is always reactive, never proactive. Effective regulatory change is relatively rare. Even successful cases tend to be highly protracted affairs; some taking multiple years. Regulatory change produces winners and losers and potential losers will fight at every stage of the reform process. Some potential losers are economically very strong. The financial sector is dominant part of the economy, but economic dominance must not become politically dominant. Such an outcome must be avoided. Failure can be avoided by invigorating both institutional checks and balances and political checks and balances. This means fair and equal access as early as the agenda setting stage for all stakeholders. The Commission is said to be so 'over-lobbied' by stakeholders that it often closes the door on the little people. There are interesting solutions provided in proxy advocacy and trilateralism. The financial industry is not homogenous. One recommendation is for public officials to support 'matchmaking schemes' that enable a more balanced interest representation. This is true for all policy areas but a fortiori for financial services.

Robert Jenkins said that this currently is the greatest credit bubble in history. Bubbles always feature greed, stupidity and leverage. The most recent bubble has a stronger component of excessive leverage than previous bubbles. The former two problems cannot be addressed, but leverage ratios have to be addressed. There may or may not be progress on Basel III but Basel III does not make any significant reduction of excessive leverage. The risk-weighted asset approach is gamed and manipulated or the subject of misjudgement. Even if the Basel standard risk weights were applied, there would still be a dependence on the judgement of the regulators. Regulators are not infallible: they got it wrong last time round. Basel II required little loss absorbing capital: 40c for every €100 of CDO-squared exposure. Basel III requires €1.33 for every €100 of exposure. On leverage ratio, he said that the new Basel rules will enshrine a permission to borrow for every €100 of balance sheet to fund it with €97 of borrowing, with only €3 of loss-absorbing equity. He does not think this is progress.

Sharon Bowles MEP said that there is a regulatory political gap. This is about democracy. As a result of the financial crisis, many members of parliaments throughout Europe lost their seats and governments fell. The regulators, who had been making the rules leading up to the crisis, do not seem to have fallen in large numbers. Therefore, can it be right to have everything regulated in a technical committee without accountability? There was G20, a political process, then the technical process in Basel. In Europe, in order to make it work, politics has to enact the law towards the end of the process. Then, at this late stage, politicians fiddle around with the suggestions. She is pleased she influenced the rules on risk-weighting and trade finance because she thinks it was the right thing to do. Basel was too strict. The Basel apparatus is trying to make sure that everybody does everything exactly the same. However, countries are not all the same. There were a lot of mistakes made by the Basel Committee. Some of their suggestions just do not work unless you have the active CDS market that used to exist in the US. It does not work in Europe.

From time to time, somebody needs to stick their neck out and talk about it. The G20 made everything worse unintentionally. What they should have done, is to look at how to resolve a bank. There was 'too-big-to-fail', banks were going under, but nobody thought how to resolve a bank. That then, would have led to a lot more sensible approach to ringfencing and capital requirements. Resolution should not have been the first sign. It was a tick-box approach to 'how many pieces of legislation have you done?'.

In Parliament, things moved so fast that important discussions disappear into shadows meetings and in the opacity of trilogues. It's a serious problem. It is not right to say lobbying is the problem. The Parliament is good at listening to the consumers. If there is a bias, it is in favour consumers. She thinks we are where we are because the regulators have made things too complicated. Of course, rules are being gamed. The risk weights is nothing to do with the banks; it's politics. There should be a corporate governance buffer, that financial institutions don't think it's in their best interest to game the rules. The US has managed to scare banks into obedience with the suspended prosecutions. If they transgress, they get punished. She thinks Europe should think to do this. The risk of transgression is so big that you don't want to do it.

Kuttner said that the regulators did take the fall but the financial system has evolved to be too complicated to be regulated. He wonders whether there is something inherently anti-democratic in the complexity of modern finance, compounded by the fact that global regulation has to do without democratic accountability to regular people.

Lewis said that the G20 principles were robust and sound. They were applied in Europe and the US. In 2009, not much thought went into how the application would work in different countries. Yes, regulators talk and coordinate. Yes, there is political will, but somewhere between national and supranational legislation there is a piece missing. He wonders whether there is a role to play for IOSCO.

Professor Mattli said that there is a lot of complexity in all sorts of regulation, if you want to really understand the issues you need good, expert rules. The difficulty is to draw in other society stakeholders. This is largely a national process and some states have been more successful at this than others.

Kuttner said that under Glass-Steagall, definitions were simple.

Bowles said that simpler is better. If you don't understand it it shouldn't be allowed to happen. Accounting standards are another problem. There are balance sheets that are difficult to understand and accounting standards that list future gains at the present. This creates the need for a credit bubble. Auditors don't want the liability. This is wrong. Ultimately, someone has to take liability.

Jenkins said that you can either fight the regulation or fight the system. You could argue that regulation is a response to the fact that the question about the structure has been avoided thus far. Lobbying has convinced policymakers that society has to choose between safety and growth, safety of banks and shareholder value and between a safe banking system and a competitive financial market place. This has been propagated so effectively to defeat the point of reform. When a bank has a €1trn balance sheet, funded with €50bn of equity and €950bn of debt. Now regulators ask to double the equity to €100bn and reduce the debt by €50bn. Does this shrink the balance sheet? - No. Have you had to cut back on credit? - No. Has society had to choose between safety and growth? No. But banks have persuaded everyone that cutting back on credit will be a consequence of safer banks. This brings politicians in an awkward position.

The second apparent choice is between shareholder value and safer banks. If you define profitability and shareholder value in terms of return on equity, this could indeed be a choice. Banks targeted double digit return on equity. Was that a good measure of profitability? Did that produce sustainable shareholder value? Certainly, less equity with a same return produces higher return on equity. However, as Sheila Bair said, the four largest banks did not do very well for their shareholders. Return on equity, for a long time, was very high. The problem with the return on equity is that it does not adjust for risk. The returns come down, and the related bonuses, but the risks come later, in the next crisis. Moreover, investors are also getting smarter, they are interested in risk-adjusted return on equity and therefore buy gilts. They accept the lower yield, in exchange for lower risk. The more risk in the balance sheet, the more the return the investor will require. The less risk in the balance sheet, the lower the return the investor will require. Capital will flow in either case, but the cost will be different. The risk-adjusted return will be the same. Banks can have lower ROE with lower risk, and produce the same shareholder value with a higher multiple. You do not have to choose between safety and value.

And finally, why wouldn't a safe, stable system be less attractive to investors than an unstable one.

Lewis said that the issue of bank lending in Europe is that there is an over-reliance on bank lending in Europe and people want other sources of finance. The capital markets in Europe have to open up to enable businesses to be funded in the sorts of ways they are funded in the US. There may be a perception that businesses are not funded through banks, but the reality is that there is an over-reliance on bank financing. This will require flexible and fast-moving markets. Economic growth can only come through open markets.

Jenkins agrees this would be desirable and acknowledges that Europe is more dependent on bank lending than on securitisation. However, a more highly capitalised banking system in Europe would have been able to take the hit and would have been able to carry on financing the economy. Banks that are more capitalised can take the hit and keep lending.

Kuttner said that there is a need for open capital markets but because of the fiscal situation there is less potential of commercial lending. There is co-dependency between dysfunctional banks and dysfunctional states. This leads states to look less closely at banks' balance sheets for fear of what they might find.

Bowles said that the bank resolution and recovery programme is trying to address this. Of course, if push comes to shove, states are likely to get involved if things get really bad, but a lot of damage will be absorbed before they wade in. Proper application of state aid rules can also help. Of course, zero risk-weighting of sovereign debt would help, but she has tried to suggest this unsuccessfully for a long time. Politically, it's at an impasse. There is still a notion to get the same treatment for every state. She is not optimistic that you can actually really break the nexus, but bank resolution and recovery, making sure you have more equity and other things can rebalance the system. It will be a long haul.

Lewis said that the Banking Union is the biggest potential structural change in a long time. It will be a major step forward. It will require a lot of political will to implement something like that.

Jenkins replied to a question about ethics. In order for ethics to play a bigger role, consumers have to be higher up the stakeholder pecking order. If you move the customer up, if your corporate motto is 'Do what's right for the customer and the customer will do what's right for your company', ethics can become more important. The reverse question is whether you can move the customer up the stakeholder pecking order without damaging the shareholder? Provided you are willing to measure success over a longer term basis. If you present a compelling enough proposition, the market will attach a higher multiple to that company. Jenkins thinks that ethics can be more important.

Kuttner said that a market where the consumer comes last is a failed market.

Jenkins said that putting some people in jail could hammer home the reform. The Financial Services Authority, now the Financial Conduct Authority, seemed powerless to hold individuals liable, but they have a process of authorising persons. So they could have withdrawn the authorisation for all the directors of all the banks that failed, somebody has to have the courage to act.

Bowles said that anything on criminal sanctions falls under Member State authority. It is aggravating for the Parliament.

Responding to a question on lobbying, **Professor Mattli** asked why so many people with knowledge are not entitled to be involved in the policy process. There needs to be transparency. He is hugely impressed with Gary Gensler's proposal to publish summaries of every meeting that takes place. There is so much more work to be done. Transparency on lobbying needs to be enforced much more strongly. He criticised IASB. The Board is largely made up of non-European representing European interests. Stakeholders also need to be educated about the processes.

Lewis said that there is a lot of misunderstanding about how dossiers move in Brussels. Maybe this will never be perfectly transparent, but there is a challenge to make it a little clearer.

Jenkins said that in the US, a number of Congressmen wanted to raise capital levels. Their mission gained momentum when they got the community banks involved. No part of the financial sector has a greater stake in financial stability than the investment firms. Yet they are the most silent.

Bowles said that generally, rapporteurs make their documentation on lobbying public. However, there is only so much one Committee can do and the Secretariat won't sign up to things that are not the same. She said that, as a whole Parliament is very sympathetic to consumer organisations, but she, and a number of her colleagues, have had bad experiences. In any case, she likes to have position papers ahead of the meeting. Once a dossier is in trilogue, it is too late for lobbying. It's all political at that stage. The process are difficult, even for her, there are parts of the process that are not public.

Jenkins responded to a question on financial jargon. There should be a rule that you can't called a 'bank' if not at least 51 per cent of your risks are tied up in the real economy.

Bowles responded to a question on the asset quality review. The credibility of the ECB is on the line here. There are other issues, like transparency.

Kuttner agreed that the stakes on this are uniquely high. This is not just about the financial system but about democracy.