Securities Regulation in Europe after the crisis

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CESR

- Committee of 27 European agencies in charge of securities markets
- Similar committees for Banking (CEBS) and Insurance (CEIOPS)
- All competences are national
- Increasingly EU regulation (Directives)
- Coordination of national actions

Role of CESR

- Advisor to the EU Commission on regulation
- Convergence of national regulations
  - By: interpretations, standards, guidance etc.
  - Coordination of national supervisory action
  - CESR is not a supervisor
  - Its actions are not legally binding but de facto have much authority

Changes in the supervisory structure

- 25 February: de Larosière report
  - More centralised decision making
  - More homogenous rules
  - Institutional structure: agency or EU institution?
- More important for banking
  - Macroprudential will go to ESCB
  - Microprudential: Hub and spoke system, but how ?
  - Problem of fiscal support is key
- Discussion in European Council, further developments, submission after election and with new Commission

Response to the crisis

- The crisis is essentially a banking and markets crisis
- Insurance indirectly affected
- Securities: where CESR was involved
  - Investment funds
    - Money market funds
    - Hedge funds
  - Madoff
  - Clearing and settlement
  - Equity and bonds: no deficiencies- disclosure
  - Cds: CCP for systemic risks

Specific Actions

- Credit ratings agencies
- Valuation of illiquid assets
- Hedge funds
- Short selling
- Lehman
- Madoff
- CDS and CCP
- Training and common culture
- Institutional questions

Credit Rating Agencies

- Credit rating Agencies
  - CESR undertook assessment on the basis of IOSCO code in 2004 and 2006
  - EU Regulation proposed and almost adopted
  - CESR as umpire of the process in the hand of the National authorities
    - No binding legal power
    - Coordination of action of the national supervisors
    - Secretariat
    - Advisory role – help in solving conflicts

Credit Rating Agencies

- Is there is going to be one centralised supervisory body, CRAs are like to be the first assignment of CESR.
- Requires CESR decision to have binding force in each of the member states

Valuation

- IRFS Fair value: comparable to US GAAP
- Process: Commission endorsement of IASB standards
  - Commission and Parliament could block=power struggle
- IAS 39 on derivatives: strict version of "fair value" but not very coherent: loans v. bonds.
- November 08: Reclassification allowed from the banking book to allow alternative accounting methods: essentially DCF
  - Fair value: market – but no markets anymore
  - Held to maturity
    - On the basis of discounted cash flow, or similar method
    - Considerable effect on the results: CESR study expected
    - Are these result fictitious: no if these assets had been booked in the banking book from the beginning.

Valuation

- Revision requests
  - Commission pressures IASB into changes e.g. on embedded derivatives, on fair value option, on insurance.
  - IASB reluctant to respond.
- Political discussion
  - Agreement EU-US aligned
  - Roadmap on introduction of IFRS in US: is it still valid?
  - Adopted for non US issuers: 3rd Q 2008
  - US issuers: process halted under new SEC
  - IFRS adopted by EU + promised by Japan, India, China, Canada, St Korea, etc.
  - To be revisited later

Hedge Funds

- Many managed from London, but established in the Caribian (Cayman islands eg.= no taxes)
- Light regime: registration for managers, not strict follow up
- Fear that crisis would have started there: nothing happened, until recently

Hedge Funds

- Proposal by Comm: regulation, but what? Conference Friday
  - Systemic danger: leverage, effect on markets
  - Market abuse:
  - Remuneration ? 20% up only.
- Iosco text adopted last week: regulators should know.
  - direct/indirect regulation esp. systemic funds
  - Extend market abuse rules
  - Should leverage be reduced

Self regulation

Hedge Fund Working Group: principles; systemic awareness.

- US will also act but how ? Very soon

Short Selling

- Ban introduced in most states in October 2008
- At state level
  - Many had no clear legal basis
    - Market manipulation
    - Fair and orderly markets
    - No express mandate
- Urgent matter: downwards speculation against the banks
  - Clear case how not to do it:
    - Ineffective
    - Large differences
    - Not verifiable
    - etc

Short Selling

- CESR will opt for a disclosure regime
  - With aggregate disclosure to public upon crossing certain %
  - Only net positions
  - Immediate reporting, but delayed publication
  - Timely settlement : Stronger enforcement
- Later: work on settlement:
  - What is naked shorting ?
  - If a ban has to be imposed, how should it work
  - How relate to derivatives, esp. CDS

Lehman

- Big shock: started the banking crisis in the EU
  - Start of confidence crisis in interbank market
- About 3000 companies in the EU: SPVs
- Liquidation under UK regime: administration
  - Will take years
  - CDS have been unwound in Clearnet : orderly unwinding
  - Several major investor protection issue:
    - Lehman certificates presented as capital guaranteed
    - Were prospectuses used, what was a prospectus
    - Advise to investors, suitability
  - Liability of selling banks: voluntary action

Lehman

- CESRs role: lessons to be drawn
  - Obtaining information on effects of failure
  - Determine what are the regulatory lessons: Mifid, clearing and settlement, rehypothecation, etc
  - Misselling: did suitability test apply?
  - No prospectus used
    - Above € 50.000: Free offering
    - Complex products: wide use of derivatives: what is complex

Madoff

- Upmarket damage
- Austrian Bank Medici: tale over by state
- Santander: 2,5bn; BNP: 0,5 Bn.
- Investment funds: 1,8 bn
- Issues of subdepository
- Wide range of victims
  - Insurance, pension funds, foundations etc.
  - No small retail investors directly

Madoff

- Role of CESR
- Collecting information, analysis of what went wrong
- Regulatory lessons, eg. Sub-depository
- Cooperation from SEC
- Press release referring to Madoff Trustee
  - First case of effective investor protection

CDS

- Systemic risks are considerable: strong pressure from Central Banks and political authorities
  - Does it make sense to allow such a mountain no nominal contracts- should one not forbid cash settled CDS (derivatives)
- G 20 and FSF: reduce risk essentially by CCP
- Central Counterparty will reduce outstanding
  - Netting of positions can considerably reduce risk
  - See Lehman liquidation
  - Continuous netting needed: not on an x + 3 basis

CDS

- Controversy: one or several CCP? Competition !
- Industry: all in NY, DTCC subsidiary along with Warehouse
- The EU wants a European CCP for local CDSs
- Depend on which reference names: EU or US
  - Indexes
  - Single names: standardisation – isda proposal fortcoming

A cross system link US-EU would contribute to complexity

But efficient systems on both sides are needed

Links to Central Bank Money for payments

CDS

- Warehouse
- European “Warehouse” needed -
  - registration, - safety of assets
  - linked to CCP
  - would deliver data for supervisory purposes
  - would also make market more transparent- pricing for valuation.

The Present Supervisory Architecture

- Based on national competences: bottom up
- Coordination by mutual recognition, home- host arrangements and cooperation
- Has proved unsatisfactory: home host system has not worked in the crisis: ring fencing in some states
- New scheme needed

The New Supervisory Architecture

- Czech proposal
  - All financial business is local: to be put in a separate subsidiary with local supervision and fiscal support
- Home Host creates dangers for both home and host

  Double supervision, or gaps in the system
- Inefficient: increased cost, local regulation, no overall view.

A European Scheme ?

- Many solutions possible
- Improve the present cooperation scheme
  - More room of the Committees
    - Soft instruments: name and shame, but too soft
  - Colleges: in good times ok, not in bad times
  - Home Host creates dangers for both home and host
    - Double supervision, or gaps in the system
  - Improve on enforcement but how?
    - QMV – Mediation, Delegation of tasks
    - Not legally binding
    - No enforcement against sovereign states or their agencies

Institutional schemes

- Create a European Institution
- Based on Hub and Spoke formula: see ECB
  - Stronger central regulation, local implementation
  - Solves question of fiscal support:
    - Local supervisors represents the state and taxpayers
  - Enforceable central decisions against Local Supervisor
- Requires change of the Treaty
- Integrate 3 pillars? Banking, Insurance, Securities
  - Or two peaks: Dutch model.

Institutional scheme

- Incorporate prudential supervision in the ECB
  - Art 105(6) allows to do so by unanimous decision of council and decision of Comm and EP
  - Would not include insurance: art 105(6) excludes insurance
  - What with securities?: Conduct of business for all sectors
  - No fiscal backing
  - Unlikely except for macroprudential matters
    - Upgrading the macro-prudential function of the ESCB eg.in the Banking Supervisory Committee

Institutional scheme

- European Agency for CESR
  - Reluctance
    - Strong position of the Commission: members on the board, financing, budget, policies
- Agencies have no regulatory powers
  - Only: Individual decision making, e.g. aviation agency
  - Here: CRA's, Clearing & settlement, UCITS, Prospectuses
    - Not optimal: CESR become competitor of its own members and creates distrust with its members
    - Does not solve the problem that is "regulation"

Next Step

- De Larosière Report
- Inter institutional Dialogue
- Agreement of the Member States
- Separate workstream from the G 20 – world wide basis