

Panel 6

Supervision and systemic risk: How to foresee and prevent it?

Moderator:

Francisco Alvarez Molina, Member of CIFA's Advisory Board, Valencia

Speakers:

Chris Cummings, Director General, Association of Independent Financial Advisers (IAFA), London

Jean de Demandolx Dedons, Member of the Collège de l'AMF, President, J. de Demandolx Associés and J. de Demandolx Gestion S.A., Paris

In introduction to this panel, the moderator **Francisco Alvarez** made a clarification about a word often used in the discussions: regulation. "There is a distinction between regulation and supervision. In Spain, and I believe in other countries, the CNVM, which is the equivalent to the SEC in the US, is not a regulator. It is a supervisor. Regulation means setting rules, i.e. writing the law. And this is done by politicians in Parliament. The CNVM, or supervisor, only applies the law. That is its role, not to set or modify the law. I believe it is important to make that distinction, because in the end, if it is the politicians who are responsible for regulation, we need to be aware that these politicians are elected by citizens. So the regulator are the citizens, that means us! We should always keep this in mind, especially when elections happen."

Before starting his remarks, **Chris Cummings** gave the context of the IFAs in the UK. "Our profession is responsible for 76% of retail financial services transactions measured by value, so we provide a competitive force in the UK market", he said. The organization he heads looks after firms that employ 128 000 people, and range from several thousand strong firms to single self-practitioners. The prevailing model of IFAs in the UK is very much an advice-led model rather than a sales and distribution led model, said the panelist. "And I think this is how the future will continue to be in the UK", he added. Chris Cummings remarked that his organization counted no systemically important or "systemically dangerous" institution, so with regards to the panel's subject it allows him a dispassionate view, as somebody who has been observing a regulator coping with the banking crisis. "So the subject of my presentation is to give you an ant's eye view of systemic risk, and the lessons we can draw from that", he said. As a first point, the panelist that it was impossible to

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prevent bubbles and the failure of organizations. "Our regulator, the Financial Services Authority (FSA) used to make a virtue of the fact that it wasn't trying to impose a zero failure regime on the market, it would always say its job was to stop bad things happening to consumers, not to stop firms going out of business. That is until the big ones started to go out of business, then it remembered its primary objective is to stop big firms going out of business", he noted ironically.

So risk is an integral part of the financial market, and it is a core part of the conversation we need to have with our clients, said the speaker. If the potential to fail is part of the capitalist system, the challenge is to mitigate the worst excesses and impact on the market when large organizations do fail. The world banking crisis – a term used on purpose by the panelist instead of financial crisis – caused great harm on the world economy, employment and the health and wealth of people around the world, commented M. Cummings. So it left a strong determination across the political and regulatory classes to make sure that there would be lessons learned and to build a more stable financial regime in the future. The UK mortgage market exhibited all the typical bubble-like tendencies. Credit markets in general in the UK exhibited exuberance, said the speaker, with the development of all types of credit offered to consumers and complex and opaque forms of securitized credits. These developments lead to a "financialization" of the UK economy, with the number of jobs either in or dependent on financial services rocketing, to the extent where the UK's primary purpose was involved in financial services, said the panelist. The prevailing political and economic philosophy was that increased financial activity was generally a good thing and to be welcomed. "The greater liquidity, the increase in trading and innovation were all seen as social good, and it was up to the regulator to get out of the way of organizations who were conducting these activities", said M. Cummings. So the regulator took as its mantra that its role should not be to intervene in markets, and far less to get involved in banning products or dampening down exuberant markets and cool volatility. The FSA saw its job as to make sure there was disclosure and transparency, which were seen as the steadying forces in the market. The result was disclosure documentation reaching new length and depth. "In many ways it was like handing over a telephone book to retail investors, except it was less useful", ironized the panelist. We have always known, he said, that people do not read disclosure documentation, so the regulatory philosophy was contradictory. "We had in effect regulatory schizophrenia", the speaker argued. Then the crisis hit, and the authorities found out that "markets didn't actually work in the way they were supposed to". The current situation in the UK is that financial institutions, including IFAs, are told to hold more capital. "Indeed 'counter-cyclical capital' has become the accepted mantra of the regulator, and because we are caught up in this regulated market, this is also having effects on my members", explained M. Cummings. "Remember we are not systemically dangerous institutions, but we are told we have to hold more regulatory capital". For a typical IFA, by the

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end of 2012 they are required to have £500 000 worth of capital on their balance sheet. Further, the professional indemnity insurance requirements have also increased. "We have also seen conduct of business regulation reinvigorated in the UK, and we have a more intrusive supervision regime being visited upon us", said the panelist. "At first we had rule-based regulation in the UK, but rules were seen to be terribly prescriptive and not very user-friendly for the firms. So then we moved to principle-based regulation, and this move cost regulated firms about £50 million. Principle-based regulation not having worked, we now have moved to outcome-based regulation. So we are on our third regulation philosophy in about four years". Outcome-based regulation gives the regulator the ability to intervene in a firm's business model, explained the panelist. The cost of this new regulation is significant, the regulator's budget for 2010 is £500 000 million, and the FSA employs nearly 4000 people. "For the IFA community, we are being asked to pay 20 pence in every pound towards the regulatory costs, so our regulatory bill this year, just for the FSA, is in the order of a hundred million pounds. We are not systemically dangerous institutions, we have been victims of the banking crisis, we didn't start the banking crisis and more importantly we never asked the UK taxpayer to bail us out. But the regulatory burden falling on my member firms has increased substantially."

As for the solutions to the bubble tendency and the systemic risk, Chris Cummings offered six insights. The first solution is a global response. The chairman of the FSA, Lord Turner, has been campaigning for the establishment of a World Trade Organization for financial services, a global body with legal powers that could actually implement financial services regulations. The second point is to look at the European response. "It is interesting to see how the various supervisors have come together to talk about the banking crisis and the issues of how that is being addressed. But I am worried that we are in the process of creating global walls, with the European commission creating solutions that work for Europe, the Americans creating their own solutions and Asia creating ones that work for Asia. All this will do is reinforce the problems by pretending they can be hidden behind regulatory walls", noted the panelist. He also made a clear distinction between regulation and supervision: "Regulation is about the creation of rules, supervision is about how these rules are policed and enforced in home states". In the UK, most of the regulation actually comes from Brussels, but is then "gold plated" in UK rules. "We are super-equivalent to what most European directives say", commented the speaker. This actually brought about an anti-competitive position in the UK in many situations, he further argued. There also needs to be a distinction between supervision and enforcement, in his view. "In the UK we have a dichotomy, although we look to Brussels for many of our rules and for some of the supervisory activity, we actually look to America and the SEC for enforcement. And this mid-Atlantic position might eventually put us in the worst of all worlds: rules that are super-equivalent to the rest of Europe and enforcement that is dominated by a criminal focus brought over from

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America. And that would make the UK deeply uncompetitive compared with other states around the world", concluded the panelist.

Moving on to the challenges within the firms, Chris Cummings emphasized the challenge of compliance and audit. "The challenge really is to know who the compliance works for. An aggressive CEO can subordinate the systems and controls in place. So should the compliance work for the Chairman, the non-executives, the shareholders, and indeed should they report to the supervisor? I am not suggesting this is the answer, but it is a challenge for us all". Finally the speaker turned to the responsibilities of shareholders and stockholders, "who were obviously sleeping behind the wheel when most of these things were happening". There was a lot of shareholder pressure, certainly in the UK said M. Cummings, demanding of their bank why they didn't achieve the same returns as Northern Rock, the first bank to fail in the UK during the crisis. "I think it is very important that shareholders understand the questions they are asking and indeed the direction they are driving senior management in", said the panelist. In conclusion, M. Cummings said he wasn't sure the solution was regulatory. "If you give people more rules, the bad guys will just find ways around the rules and the good guys will end up paying more because of the rules. So I am not sure I would advocate a rule-based solution". Two questions have to be considered, he continued: "what role do we want these systemically dangerous institutions to play in our society, and perhaps most importantly, what do we expect from the people who are running them? If we expect them to come from religious orders, then that will dominate the style of corporate governance. If we expect them to be normal failed human beings, the they will need systems and controls put around them".

Jean de Demandolx explained the recent regulatory and institutional developments in France as a response to the financial crisis. First, the French government has decided to centralize the supervision of the banking and the insurance world, merging the different regulators who were supervising the banking and the insurance industry. There is now a new regulation body which is headed by the Governor of the Bank of France, with a vice-chairman who is coming from the insurance world. They have two different boards, a banking board and an insurance board. And they employ over 800 people to address the systematic threats and the control of the insurance and banking world. Beside that, the securities market is under the supervision of the *Autorité des Marchés Financiers*, the AMF, which is an independent body comprised of 16 board members, called commissioners of the State, *membres du collège* in French, who are being named either by the President of the French National Assembly, the President of the French Senate, the President of the *Conseil Economic et Social*, by *la Cour de cassation*, the *Conseil d'Etat*, the *Cour des comptes*, and then six are being named by the Minister of Finance. The chairman of this AMF body is M. Jean-Pierre Jouyet, a former politician, but the managing director is in fact the person who manages the 300-400 people working at the AMF to follow mainly the securities markets, mainly insider trading. The AMF controls and supervises the 3000 IFAs in France,

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the 500 investment management companies, roughly 500 banks and financial institutions and roughly 300 insurance companies, who are selling investment products. Between these two bodies, explained the speaker, there is a *pole commun*, which receives all the complaints from different investors, either because they are unhappy with the banking products that have been sold to them, or the financial products or the insurance products which have been sold to them. The complaints go through this common pole, and are then directed either to the AMF or to the ACP. "The idea behind all that is that the investor is the key element. It is in the law, *la protection de l'épargne*", said M. de Demandolx. How this will be implemented is another question, he added, but the intention of these two bodies is to be at the service of the investors, mainly the private investor. France, noted the panelist, was lucky enough not to be too heavily touched by the Madoff, the subprime and the toxic products of Goldman Sachs and Morgan Stanley. Why? "Maybe because we were a little bit cautious, maybe we were not very bright, or maybe we were very smart as since we don't understand what these products are, we don't touch them", he said. In the AMF, there are two important bodies in terms of control. One is the *service des enquêtes*, the investigation section, mainly following insider trading, market manipulation, and so forth. Then there is another body inside the AMF, which is the normal supervision of the investment banks and investment management companies. The control of the IFAs in France, said M. de Demandolx, isn't done by the AMF, but by six professional associations who have the delegation of the AMF to control the 3000 IFAs in France. "It is quite new, they are indirectly under the control of the AMF, but it is the role of these associations to do the learning, the control to accept them, and to control that they are doing their due diligence", explained the speaker. What about the future? "I think that the investing public in France is a little bit afraid of what is going on, and therefore they stick to the large banks, and even if they don't earn much, they are not going to buy bonds or shares", said M. de Demandolx. In the future, with these new controlling bodies in place, in theory the investors should be better protected. But fraud is in the nature of the human being, reminded the panelist, it is a question of education, of control, of who you hire, and how the management behaves. "There is a saying in France, *le poisson pourrit par la tête*, the fish starts rotting by the head, so if at the head of a major institution you have people who don't behave well, the whole culture of the institution will be affected", concluded M. de Demandolx, remaining open to answering questions.

QUESTIONS & ANSWERS

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Francisco Alvarez

Let me start with a question to Jean de Demandolx: you said something very important to me, which is the importance of education. We talk about the education of the investors, but I often find that the people in charge of financial regulation don't have really high education in financial matters, what do you think?

Jean de Demandolx

To be very honest, I would say that at the AMF level in France we have not enough seniors, as the AMF has not been able to attract high professionals from the private sector. They prefer to hire juniors, who are being brought up in the hierarchy, and I am not so sure this is a good way. When the SEC was established, if I remember correctly, it was established with people from Wall Street, who had been on the other side, who were not very good citizens, but then they moved to the other side. And I think we should have more seniors in the FSA, in the SEC, in the AMF, people coming from the private sector, who are 55, 60 years old. These people know what is going on in the trading rooms, they know how these products are being created, and therefore we would be much more efficient.

Chris Cummings

At the risk of being controversial, I would simply reflect that of the eight most senior people in the FSA, eight of them have a banking background. But it hasn't worked terribly well for us, so let me not commend this to you as a model. That could just be a unique UK experience. The second thing I'd say around education, we are very big on financial education in the UK at the moment, and the industry is being asked to pay a £50 million bill per year to start a financial education body, and it seems that this is the next holy thing that is just going to solve everything. So at first we had information, we had to give people a lot of information and they would understand. Well that didn't work, so the next thing is if we educate people then that will work. And I think education is perhaps necessary but entirely insufficient. What we need to do in financial services is just find a way to make our product less esoteric, base them back in normal everyday human life, and people will understand them, and we won't need to spend millions of pounds to explain what CDOs and ETFs are, we might actually come up with a range of products that people are interested in buying. Because at the moment it seems to me that, again UK experience, that our regulator focuses on the supply side all the time. It always wants to change the industry. And all that is happening is that the gap between the industry and consumers gets wider and wider, because as an industry and our regulator, we spend all of our time talking to ourselves. And so I am not convinced that education actually will solve the problem. But it won't make it worse.

Question

Don't you think that regulation and over regulation and super regulation is essentially due to political needs, for the politicians to give the

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impression that they are doing something on an industry on which they have little control, which they themselves don't understand? It is just an illusion, because as we all well know, regulators and over regulation doesn't help in any way the security or the strength or the honesty of the industry.

Chris Cummings

I think a certain level of regulation is a positive thing. I like regulation that keeps the bad guys out of the industry and captures the crooks as quickly as possible and looks after consumers. After that, everything else becomes entirely debatable. And certainly in the UK, we have a political class that often mistakes action with effectiveness. If I look at the last four years, all the major changes that we have been through, actually all that has happened has made financial services products and access to advice a lot more expensive. So because of political action, fewer people will actually save, buy protection, take better investment and better manage it. But the politicians have presented it as being the right thing to do, without understanding that actually it just puts costs on an industry and therefore that increases prices.

Jean de Demandolx

In France we say that politicians are not really interested in all these matters, it is more at the ministry level, the government level, in these different financial circles that all these debates are being discussed. Don't forget that in our organization, the AMF, there are *Commissaires du gouvernement*, i.e. a representatives of the Treasury office, who are sitting on our board and are being really active. In fact a lot of decisions which have been presented to us have been discussed between the AMF staff and the Treasury before being presented for approval at our board level. So politicians haven't played a real role, it has been much more the government which has been instrumental in all the new reforms that have happened in France over the last four years.

Question

A question related to the comments of our colleague Chris, regarding the number of complaints from the public compared to the humongous number of transactions which are generated by the IFAs, which is obviously unbelievable compared to the number of complaints which are launched against the banks. Isn't a solution finally the smaller units, with people who are engaging their reputation and their capital, a model for the industry. Because those huge corporations in finance are virtual, whereas the small independent advisors or the medium companies has a lot at stake. I think this is where we have to work and I would like to ask the panel about this.

Chris Cummings

This is the sound of me not disagreeing with you... What I would reflect on is that, when I used to be a director of a bank, we recognized that complaints were just part of being in business, and that every month we

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would get a bill from the complaints service, the ombudsman, and at some point we would write a check and send it in. That was just a cost. At no point did anybody come to me and say "because we have had complaints we are going to have to deduct that from your salary this month." Now for many of my members, if they get complaints, it goes to the ombudsman service and the complaint is filed against them, it is their personal money, certainly their business' money, so it affects them as individuals. So I think the motivations are entirely different, and that is why for intermediaries, it is all about wanting to do the best service for your client, but it is more than just a philosophical statement, it is actually a financial imperative! And I think that separates the two things out very clearly. In the UK we finally managed to persuade the FSA and the ombudsman service to start publishing the names of the organizations who are most complained about. It has always been my view that the way to get big organizations to take their complaints seriously is to make it an issue that analysts ask questions about. "I see that you are the most complained institution in the world, what are you doing about that?" would seem to be an interesting question at an analyst meeting. And so now that we have got more transparency about who gets most complaints, and actually benchmarking can be introduced, that might help consumers actually get a better deal from financial services. I think this is the way forward.

Question

We heard a lot of comments this morning about the differences in terms of regulatory authorities in the UK, Spain and France. I would like to ask the panel what they think really about if we should be making a conscious effort to move towards a pan-European type of authority, with more teeth, so that in the view of the nature of the financial services business, which is more and more international, with the banks working in all markets, there really can be one uniform approach. I take as an example the MiFID regulation, which for all its faults, certainly in terms of its intentions, is actually trying to protect the consumers, make the markets more transparent for the consumers in terms of costs, of actually purchasing shares or bonds. It was born of good motives, I want to ask the panel what they believe in terms of whether we should be moving towards a stronger pan-European authority?

Jean de Demandolx

I totally agree with you, but it is the case, you know there is a committee called CESAR, which is the body of all the European regulators. And this body is going to have more influence with Brussels, from being a mere consultative body it should become an agency. In terms at least of the securities markets, there should be a more European approach. Now on the other side, on the banking side, there are some movements but there are a lot of reluctance and our dear friends over the Channel don't like Brussels very much, so therefore the discussions at CESAR are difficult and mainly with our British friends.

Chris Cummings

When I look at what is happening at the Lamfalussy committee moving to authorities, and CESAR and such getting extra powers, it is one of those things where I think we are arriving at our destination without realizing that we have set off, and asking people if that is where they wanted to go. Actually I am a Europhile, I believe in the European ideal, I am just a little bit concerned that things happen and then suddenly we realize we do have a pan-European regulator, without anybody asking, so we end up in a de facto position. So I am torn actually, because as a good European I would say yes, the more harmonization we have, that is going to create competitive advantage for my firms, and that would be a good thing, we could do more business across Europe. If I was being a cheerleader for British financial services, I would say maybe, not sure, we do things a bit different, and London has a particular place in the global financial services industry, and I think we could lose that with greater harmonization. So I am going to be without giving you a straight answer I am afraid, because I find myself completely torn between those two things. But I would say I would actually like a more open debate on that subject, because I think we are heading in a direction of travel that will take us towards a European single regulator and I am not sure whether it is a good thing or a bad thing, and I think it is one of those things where we need a more public debate about.

Question

On that point, I think the agenda is really being taken over by the fund industry, who are unable to resist this huge flow towards Brussels under the new AIFM directive, which is basically enforcing the UCITS framework on anything that calls itself a fund, including hedge funds, and also therefore to some extent excluding the Americans and giving the UK a hard time, making everybody with funds in the Cayman, of which there are over 10 000, having to think of redomiciling their funds or bits of their funds and management company, the administrator or whatever. That being the case, the independent advisors will be subject to European rules in any event. And it seems this will come into force quite quickly, although there is a big debate about it.

Chris Cummings

Certainly from an IFA perspective we are already subject to MiFID, to the IMD, and of course we are part of the PRIPs discussions that are going on at the moment, and we have home state supervision on top of that. So we are used to having to reconcile the demands of our UK regulator, and I think it is now the sixth European directive that are currently being discussed, all of which have a day to day impact on the life of our members. And certainly the alternative investment management directive is a clear case in point about continental Europe being of a view, and the UK and America being of a different view, and how we reconcile that, I have really no idea. But I think it was telling that that discussion got kicked into the long grass until after the UK general election.

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Francisco Alvarez

Something surprises me, if I understand well, all these bodies, their main objective is to protect the investor. Are the investors represented within those bodies?

Jean de Demandolx

Not officially, because there are no large organizations representing the consumers or investors. I think we are two at the board level at the AMF who are really on the investment private side, one who is representing companies, because he is l'actionnaire salarié, i.e. shareholders who are employees of a company, and myself as a private investment group.

Francisco Alvarez

I know in Spain it is very similar, but I think that in the same way you describe, and I think it is a good idea, concerning the advisors, you said that in France, the AMF decided to somehow co-regulate with some associations. So I think that somewhere, if we decide that these bodies are there to protect the consumers, the investors need to be in it, not because there is nobody representing them, they need to be represented directly!

Chris Cummings

In the UK it is slightly different. The same act of Parliament that set up the Financial Services Authority also set up the Financial Services Consumer Panel, as a check and balance. So in the FSA's planning it has to consult with consumers representatives, there is a consumer body with a statutory mandate. Also on the FSA's board are a couple of leading consumers, and we have also recently had an IFA appointed to the FSA board as well. And we are particularly pleased by that. So consumer groups in the UK are very strong, they find a way to influence both externally and also by being inside the tent as well.

Remark

Yesterday in my presentation I mentioned the fact that the Senate of the United States was debating a bill, one provision of which was to create a systematic risk control panel, which would have the task of trying generally speaking, not only with banks, to see if they were becoming "systematically dangerous" for the economy. And the news I want to bring you is that the bill will be voted on in all likelihood, the provision that I mentioned will become law in the United States, so that we will have a systematic risk control panel. The other thing I want to mention on this issue of possible breaking up of the banks, there is an amendment that is going to be introduced to the bill, in the Senate, which will call for just that. So I simply want to share those pieces of news which incidentally indicate just how timely this panel called together by CIFA is, literally the laws are being changed as we speak.

Chris Cummings

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In the European Commission of course there is the Financial Stability Board, which has a very similar mandate to what has just been agreed by the US Senate.

Remark

President Obama just signed into legislation on March 18th something called the Higher Act, and part of this is something called FATCA, which is the foreign accounting tax compliance act, and that is something that affects every single one of your members, every single one of you who actually invest in the United States. It is a compliance burden that the US government is putting on every single investment in the US, so it is something that people should stand up and take notice of. There is a number of seminars being put on by various organizations, and I would highly recommend you to pay attention. The United States is looking to raise some serious revenues from any foreign investment in the US.

Remark

Literally from today's newspaper, President Obama has nominated now three people to the board of the Federal Reserve Bank. There has been the unusual situation of not one, not two but three appointees being necessary, and I can mention the names afterwards with you, but the analysis of the appointments are that they are people who are not going to be pushing for an increase in interest rates anytime soon, they are more interested in the economic recovery than in the potential inflationary impact of the actions of the Federal Reserve Board.
