

A new world order?

After the recent G20 meeting in London, and the FSA Turner Review, the EU Larosiére report and various other initiatives, many in the industry are speculating that we are now beginning to see the first co-ordinated response to the financial meltdown of last year, perhaps even a new regulatory framework for the industry. **Neil Ainger** canvasses some opinions from various industry representatives, consultancies, trade bodies and vendors

The turbulence that has hit the financial services industry over the last 18 months has already affected the sector in numerous ways with many august names, such as Lehman Brothers, disappearing and others, such as Alliance+Leicester, being swallowed up by larger rivals, like Banco Santander. The meltdown of the financial system also necessitated the rescue of numerous banks by governments and large amounts of insurance money have had to be pumped in to try and remove toxic assets, while trust has been adversely affected by the Madhoff pyramid scam and other revelations. All of these shocks to the system and the subsequent downturn will undoubtedly change the financial services sector in the years ahead, just as the 1929 crash and other downturns have in the past – for instance, a separation of commercial and investment banking has been enacted in the past to try and protect certain areas of banking. What lessons can we learn to try and ensure that another credit crunch doesn't happen again? Will the G20 proposals set out in London during April form the basis of a new framework for the financial services industry and did the politicians get it right? Was there too much regulation proposed, covering everything from counter cylindrical accounting to pay and bonus controls, or too little? Are hedge fund controls really necessary, as Germany and France seem to believe; can action against tax havens really work; and how will the new liquidity requirements and Financial Stability Board, replacing the old stability forum with a strengthened mandate, affect the framework for financial services moving forward? As ever with these summits we wait to see if the G20 commitments (see <http://www.londonsummit.gov.uk/en/> and our March-April edition for more detail) are followed up and stringently enforced. But it is already clear that a new era for financial services, and its regulation, is beckoning, with new risk paradigms and structures imminent.

As Adair Turner said in the FSA's Turner Review, published on 18 March before the G20 proposals added some international meat to his thesis, the recent financial crisis has challenged the intellectual assumptions on which previous regulatory approaches were built, and in particular the theory of rational and self-correcting markets. "The changes we recommend [in this Review] are profound and the banking system of the future will be different from that of the last decade. The world's economy will be better served as a result," he said. Is it true

though that the economy, and the financial services industry, will be better served by the new framework being laid out by the G20, Turner Review, EU Larosiére report, and the moves towards establishing centralised CDS clearing mechanisms? Do the recent initiatives perhaps represent the first indications of how the industry might look in a couple of years' time? Could these initiatives individually, or cumulatively, change the nature of financial services post-crunch and is the technology in place to enable increased scrutiny and enhanced risk and monitoring processes. If not, the industry could face a big technology investment bill as a result of these proposals. *FST* gauged the opinion of a few industry players to see their reaction and views as to what might lie ahead:

Q. Do you think that the G20 proposals set out in London will form the basis of a new framework for the financial services industry and do you think the politicians got it right? How will the new framework affect you and the industry in two to three year's time?



Stephen Hadrill,
Director General, Association of British Insurers

We welcomed the G20 statement, as it contains valuable commitments to ensure an open world economy, strong markets and effective financial institutions. The important challenge now is for national governments and regulators to follow those fine words with sensible measures, to ensure effective regulation and prevent protectionism.

The EU has a vital role to play here in protecting the single market. The EU and the Financial Stability Forum will need to stick to the principles of modern markets and not try and reinvent older forms of regulation that belong to past eras. The UK and London, in particular, have most to lose if the fine words of today become the shackles of the future. With the ABI's members controlling 15 per cent of the UK's capital, the ABI will be vigilant in monitoring how our authorities rise to this challenge.

The G20's moves to ensure remuneration encourages long-term value creation and does not lead to excessive risk taking is also welcome. We must stress the need to avoid the possibility

of 'reward for failure'. The FSA has already produced proposals aimed to do this in the UK [in the Turner Review]. Any new steps to support that can only be good news. The London G20 also raised the issue of accounting. Fair-value did not cause the crisis and any moves to change accounting provisions must recognise the difference between financial data for investors and prudential requirements for regulators. The G20's renewed commitment to cross-border financial supervision should allow companies to use branches and cross-border sales – driving firms into subsidiarisation would have been a retrograde step.



Paul Donovan
Managing Director, Global Economics,
UBS Investment Research

The G20 summit managed to simultaneously succeed and fail as a mechanism for economic coordination. The success came from the veneer of public unity that was presented by the world's leaders. Getting twenty heads

of government to agree to a common statement at a time when national self interest is dominating is no small thing. In addition, and perhaps the most important outcome from the summit, there was a clear commitment to increase the funding of the International Monetary Fund. This has reassured the world's investors that the IMF has the resources to be able to deal with any crisis that emerges (within reason) in the coming months. Creating this capability for action should serve as a calming mechanism in the world, reducing the need for action.

At the same time, little of substance was achieved in terms of international financial regulation. This is hardly surprising – a multi-polar world is hardly likely to agree on a new financial architecture in the space of a couple of hours' meeting in London's Docklands. It took a bipolar world three weeks at Bretton Woods [in 1944], and even then the conclusions were so sufficiently flawed as to contain the seeds of the system's destruction. There was no clear agreement on fiscal and monetary responses to the credit crisis. Trade protectionism was rejected in a token manner, but the rejection was itself subsequently rejected as governments have continued to pursue economic self interest.

The conference achieved more than many such gatherings do – funding the existing international architecture [with an extra \$1.1 trillion]. Markets were reassured by the semblance of unity. However, multilateralism in economic or regulatory policy was absent (beyond the platitudes of the pre-arranged statement). The G20 has done nothing to stem the centrifugal forces of national regulation and separate regimes – and that, in the current environment, well make global finance more difficult.



Andrew Baker
CEO of the Alternative Investment
Management Association

We are very glad that the G20 has made such a significant commitment to financial stability. Last year was the worst year on record for the world's hedge fund industry and of course our members want stability returned to the

global economy as much as everyone else. The issue of financial stability is the most important currently facing global policy makers and so we welcome the new Financial Stability Board and look forward to working as closely with it as we have with its predecessor, the Financial Stability Forum.

We are determined to do everything we can to assist international policy makers in preventing systemic instability in the future and the most important way we can do that is through the provision of information. If policy makers can get, through improved information, a better sense of concentrations of risk in global financial markets, then they will be better placed to prevent future instability. We have already offered to play our part in providing this information – in our new policy platform of the 24th February we supported the provision of systemically significant information by large hedge fund managers to their national regulators. Our new policy platform also stressed our support for a global manager authorisation-supervision template. AIMA took the lead on behalf of the hedge fund industry globally in these respects and this is an endorsement of our position.

Of course it is right that systemically significant institutions should be subject to oversight. We would however note the conclusions of Lord Turner in his recent Turner Review who pointed out that hedge fund leverage "is typically well below that of banks – about two to three on average" compared with levels of up to 50 times with some of the banks; and that "hedge funds in general are not today bank-like in their activities". Although we agree that any entity that provides banking services should be regulated as a bank, we believe the vast majority of hedge funds do not fall into this category.



Joël Mérére
Executive Director, International
Policy Affairs, Euroclear. He is also
chairman of the European Central
Securities Depositories Association
(ECSDA)

The G20 communiqué is proof of a globally co-operative effort to kick-start economic growth and secure international financial stability. The G20's approach will be debated among the private and public sectors for years, and its consequences keenly followed. At the moment, it is too early to tell if the politicians got it right.

The post-trade businesses of clearing and settlement are not specifically referenced in the G20 proposals. However, recent governmental and central bank reports (e.g. by Larosière and Turner), propose more or different regulation on providers of post-trade services and this will shape our industry moving forward. While more details are needed about how these recommendations would actually work, considerations for new or changed regulation must take into account the reforms currently in place and/or being deliberated. For example, there are the ESCB/CESR's recommendations for EU clearing and settlement standards, which are soon to be implemented; TARGET2-Securities; and Commissioner McCreevy's Code of Conduct, which has already delivered greater transparency between the trading and post-trading layers.

Perhaps the G20, Larosière and Turner reports are correctly

focused. The global capital market's post-trade infrastructure has weathered the latest turbulence extremely well. As Baron Lamfalussy recently said: "The clearing, settlement and payment systems deserve particular praise. Few people, including financial market participants, let alone governments and the general public, are aware of the amount of effort that has been invested over the past 20 years into enhancing the crisis resistance of these systems. The investment has been rewarded by high returns."

However difficult it is to predict the scope and impact of new regulation, it is likely that the post-trade industry will face greater regulatory pressures. As EU public authorities consider a new Securities Directive and revisions to MiFID, among other things, it is imperative that they do not create unwelcome obstacles to competition or market-led initiatives. Although the work being done by the public sector to dismantle the Giovannini Group barriers is unanimously welcome, approaches that spark endless debate, for example, are counterproductive.



Edward Merchant
Capgemini, Head of Capital Markets,
UK & Ireland

The intentions of the G20 are directionally correct. However, well conceived policies can still fall short of achieving what was intended for a number of reasons, such as:

- Invalid assumptions about what can be practically achieved, or what can be adapted to meet evolving needs, render them ineffective;
- The resource requirements and costs imposed on firms are greater in practice than anticipated when conceived [for example, SOX]. As a result, economic results fall short of expectations; or
- A series of compromises made during implementation to accommodate local practices, capability limitations, and changing market conditions result in dilution of the effectiveness and/or increasing misalignment with the original intent [a common problem in the EU with 27 member states].

To ensure practical implementation of regulatory changes, deciding *what* has to be done needs to be underpinned by a deep understanding of *how* it will be achieved. If one views the process of defining and agreeing policy as being comparable to running a marathon, implementation should be seen as a triathlon. Obviously, the fact that this group has achieved this level of consensus to date is a cause for cautious optimism. What now needs to be seen is whether the necessary degree of resolve and focus can be sustained once the potentially expensive and tedious implementation work begins. The answer to this question will ultimately dictate the degree to which the industry is impacted over the next two to three years.

Jon Robson,
President of Enterprise for the Markets Division of Thomson Reuters

The G20 Summit set out to establish that deep structural changes in the regulatory frameworks of the finance industry

are no longer optional. Adverse market conditions exposed serious underlying cracks in the global industry's long standing fabric, highlighting that markets were not bound to any kind of statistical normality. Standardised risk measurement methodologies and uniform hedging tactics had acted as generators of rampant systemic risk.

A forward looking regulatory framework, therefore, will require financial institutions to develop specific dynamic capabilities to monitor their net exposure to the very risk factors that might affect their profitability and balance sheet viability. Subsequent assessments of risks and mitigation strategies can then be communicated promptly - internally and externally - so that managers and regulators can use aggregated information to anticipate the impact of events that could stress markets. This will drive the adoption of a corporate-wide culture of risk management that will rely on the implementation of new standards of surveillance mechanisms, set to monitor exposure and liquidity concentrations across sectors, systems and legal frameworks. We are entering a new era, where automation and ubiquitous connectivity will not only support risk-based business decision making but truly enable regulatory requirements for transparency and market discipline.



Bob McDowall
European Research Director,
TowerGroup

The proposed injection of \$1.1 trillion is absolutely necessary in promoting economic recovery. The G20 resolutions are designed to strengthen financial regulation, promote global trade and reject protectionism. It should, if successful, lead to an inclusive, sustainable and more risk-robust sector. The appointment of the International Monetary Fund to implement the proposals is sensible, but the IMF will find the task challenging. The proposals demand extreme levels of collaboration amongst nations on principles and the coordination of resources. The time pressures are also significant. Add to this, the discrepancies between national operating procedures and the technologies employed to store data and manage risk, and you have a very fractious landscape which the IMF must unify.

There is, of course, great potential in the G20's proposals. It could lead to a coordinated approach in monitoring and managing systematic risk, especially the Financial Stability Board. It could encourage technology on a global scale, achieving systematic visibility and transparency amongst individual companies. These principles are essential in ensuring the financial services industry never finds itself in the current predicament again.

In principle, the G20 proposals should form the basis of a new financial services framework, but it is up against heightened levels of protectionism as nations who have recapitalised have a tangible national interest in the performance of their financial institutions. The G20 proposals require a truly global response and as nations smart from the events of the past 18 months, it may just be asking too much too soon. We'll see.