THE FUTURE OF FINANCIAL SERVICES SUPERVISION

Response by FIN-USE to the Consultation on the future of financial services supervision in the EU

April 2009
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**EXECUTIVE SUMMARY**

In this submission, FIN-USE highlights the lack of user-representation and accountability mechanisms at the heart of the regulatory and supervisory system.

The present crisis has painfully revealed that the financial system, and the regulation of the financial system, needs a radical reform if it is to meet the needs of society.

FIN-USE considers that reforms should focus on the following:

1. The protection of customers of financial intermediaries and the users of financial services, to guarantee the effective functioning of financial markets, providing trust and confidence to savers and users;
2. A new regulatory architecture at international, EU and member state level, with a clear distinction between prudential and consumers issues;
3. New Macro and Micro Prudential Authorities, in the line of the De Larosière Report;
4. A study on the need of a new European Financial Users Authority, to take care of conduct of business issues and investor protection;
5. Financial services user representation at the heart of the regulatory system and the accountability of financial regulators;
6. A new coherent, robust to financial regulation, supervision and enforcement, including risk management and close and consistent link between supervision and crisis management;
7. Governance of financial institutions and role of long term investors.

FIN-USE stresses that the setting up of a stability (European Financial Stability Agency, EFSA) and a supervisory body (European Financial Regulatory Authority, EFRA) under the auspice of ECB needs careful consideration on at least two aspects; 1) how to ensure that relevant micro prudential considerations are included in macroprudential assessments and regulation and; 2) how to keep the macroprudential supervision on arms-lengths distance from ECB’s regular tasks and avoid conflicts of interests with the ECB’s monetary policy operations.

Furthermore, the existing level 3 committee consultative panel structure could be effective but it is no substitute for representation on the main governing board. To promote
good governance and user confidence in these bodies it is therefore critical that a minimum number of seats on governing boards should be reserved for user representatives. The board should also have a minimum number of seats reserved for emerging EU economies.

EFRA is proposed to have authority to dictate to EU supervisory authorities the appropriate regulations and standards for financial institutions. A critical question will here, according to FIN-USE, be to find appropriate mechanisms 1) to ensure that precise and independent analyses and risk warnings can be prepared, and 2) that warnings can be transformed into effective policy responses. Particularly since correcting measures will have to be implemented at national level. To further strengthen the compliance mechanism the work of EFRA should be subject to a high degree of transparency, preferably by public disclosure of analyses and recommendations.

FIN-USE makes in its submission several recommendations on how to improve user representation at EU level. These recommendations are intended to improve the functioning and accountability of the European Commission and of the important EU regulatory institutions – the important level 3 Committees (CEBS, CEIOPS, and CESR).

**Recommendation 1**: each level 3 committee should ensure that at least one-third of the consultative panels are user representatives, and that these user-representatives should have sufficient resources to undertake their role effectively.

**Recommendation 2**: each committee should ensure that the consultative panels have access to additional resources to support the work of consultative

**Recommendation 3**: each committee should establish a consumer/user expert group. The role of the expert group should be to: provide insight to level 3 committees on the impact of consultations and initiatives on consumers/users; ensure the Lamfalussy process is taking consumer/user interests into account.

**Recommendation 4**: each committee should appoint a consumer coordinator to support the work of the consumer/expert standing committee and coordinate relationships with consumer/user organisations.

**Recommendation 5**: the EC should properly resource FIN-USE as its user expert forum.
Recommendation 6: the EC should help fund the representation of financial services users at the European level, to address the huge imbalance of resources between users and the financial industries in terms of European lobbying, and enable financial users to make their voice heard at the European level.

These are our recommendations to improve the prudential regulation and supervision. But consumer protection issues also could need a new European Financial Users Authority, to address conduct of business, transparency issues and investor protection.

In its submission FIN-USE also give a brief summary of its recommendations and views on:

- Risk management
- Principle based regulation
- Governance
- Transparency, enforcement and sanctions
- Consistent and coherent regulation

INTRODUCTION

FIN-USE terms of reference provide for two main roles, they are:

- to respond to the Commission’s requests for opinions and recommendations on initiatives affecting users of financial services in the Internal Market, and
- to proactively seek to identify key issues which affect user in the internal market and produces position papers.

We are taking this opportunity to proactively submit our views on the issues set out in Annex I of The Communication for the Spring European Council entitled ‘The Programme for Financial Market Reform’ and the De Larosiere Group report.

We support many of recommendations in the De Larosiere report as sensible proposals for reforming the regulation of the financial system. However, there are some obvious deficiencies in the report. There seems to be no recognition of the need to improve regulatory accountability and user representation within policy making structures. There is insufficient recognition of the role long term investors (such
as pension funds trustees) and failure of corporate governance in financial institutions played in the financial crisis.

The financial crisis

The ongoing crisis in the financial system is more serious than was first appreciated. Ordinary consumers and businesses are feeling the full effects through reduced credit availability, while the reckless behaviour of financial institutions and failure of regulation has put at risk the savings, investments, pension and jobs of millions of EU citizens.

The present crisis has painfully revealed many of the underlying structural weaknesses of the current regulatory and supervisory arrangements in EU, one being user representation. The financial system, and the regulation of the financial system, needs thus a radical reform if it is to meet the needs of society. The financial crisis provides a once in a generation opportunity to undertake the necessary radical reform. This opportunity must not be lost. If we are to restore confidence and trust in the financial system, and reduce the risk of a similar crisis recurring, any reforms must address the underlying causes of the crisis.

FIN-USE considers that reforms should focus on the following areas:

1. The protection of customers of financial intermediaries and the users of financial services, to guarantee the effective functioning of financial markets;
2. A new regulatory architecture at international, EU and member state level, with a clear distinction between prudential and consumers issues;
3. New Macro and Micro Prudential Authorities, in the line of the De Larosière Report;
4. A study on a new European Financial Users Authority, to take care of conduct of business issues and investor protection, as a medium term proposal;
5. Financial services user representation at the heart of the regulatory system and the accountability of financial regulators;
6. A new coherent, robust financial regulation, supervision and enforcement, including risk

1 When we refer to the financial system we include financial markets, institutions, firms and individual practitioners
management and close and consistent link between supervision and crisis management;
7. Governance of financial institutions and role of long term investors.

In this submission, FIN-USE highlights the lack of user-representation and accountability mechanisms at the heart of the regulatory system. The current unacceptable imbalance between industry and user representation is in effect a denial of fundamental rights of access and representation and causes a serious democratic deficit at the heart of EU policymaking structures.

There is a perception that financial regulators were ‘captured’ by powerful financial industry lobbies and this contributed to biased selection of input by regulatory bodies and others concerned resulting in the failure of regulators to act as agents of society and regulate powerful financial institutions robustly and effectively.

We will be publishing a separate paper soon on ‘Consumer Voice’. This paper will highlight how little direct influence EU user representatives have over policy formulation and regulation at EU and member state level. We have included a brief summary of our proposals on user representation in this submission – further details can be found in the forthcoming paper.

We must take this opportunity to register our profound disappointment and disbelief that previous failures to ensure proper user representation were repeated with the creation of the De Larosiere Group. There has been no direct user representation on the Group, nor any meaningful attempt to involve users and their representatives during the Group’s deliberations. We are unable to explain why, given the impact of the financial crisis on ordinary users, it was considered acceptable to exclude the voice of the user from the group’s deliberations.

Indeed, the Group restricted its evidence taking to ‘personalities and representatives of European financial services associations and international institutions’\(^2\) including trade associations such as CEA, AMICE,EBF, ESBG, ICMA, EFAMA, FOA, and representatives of large insurance companies (AXA, Munich Re, AEGON, and AVIVA plc).

This is simply unacceptable. FIN-USE urges the Commission to recognise the severity of the collapse of confidence and trust in the system. Representatives from the same type of

\(^2\) See Annex II: Meetings of the Group and Hearings in 2008-2009
institutions that share most of the blame for the financial crisis (regulators and financial institutions) cannot be given the lead responsibility for developing policies to deal with the crisis. This undermines consumer confidence in the policymaking process.

It is now imperative that mechanisms are instigated to ensure that interests of users are represented in the future during the implementation of the DeLarosiere Group’s recommendations. The perception of regulatory capture by the financial services industry needs to be countered. This is a necessary precondition for restoring confidence and trust in the financial system and ensuring that any reforms gain the critical support of financial services users and their representatives.

**Regulatory functions**

It is important to recognise the range of different functions and activities that need to be regulated effectively if financial markets are to work in the interests of users and society. The key functions and activities that need to be regulated include:

- exchange functions ie. the operation of stock exchanges and markets;
- wholesale market activities such as investment banking;
- financial system stability/ macro-prudential regulation/ systemic risks;
- legal aspects – the basic legal and authorisation of market participants;
- micro-regulation – the prudential supervision of individual firms;
- corporate governance of financial institutions and the role of long term investors (such as pension funds and insurance companies);
- retail/ conduct of business activities – this covers how firms treat consumers, efficiency of distribution, marketing and promotion, quality of advice and information provided to consumers, the behaviour of firms and intermediaries/ advisers;
- competition matters;
- the role of information intermediaries – the behaviour of the various intermediaries that produce market information (such as auditors, actuaries, and credit rating agencies);
- redress – including financial institutions having efficient and fair procedures for handling complaints as
well as consumers right to obtain redress if things go wrong;
- protection schemes – to protect consumers in the event of a firm failing;
- good governance of financial market authorities and financial supervisors.

However, financial markets are central to the functioning of society. Policymakers must also factor in wider economic and social policy considerations such as:

- maintaining access to financial services;
- maintaining lending to key economic sectors; and
- wider economic and monetary policy.

So, any reforms to the regulatory architecture must take into account those different regulatory activities and ensure that those activities are coordinated and implemented at international, EU and member state level.

The failure to regulate and supervise effectively most of these activities to protect customers and users contributed to the financial crisis. We include these to remind the Commission, in its understandable desire to reform prudential regulation, not to forget these other important activities. Moreover, in our view, the serious regulatory and supervisory failure can be attributed partly to lack of user representation at the heart of the regulatory system. Regulators need independent and objective oversight to help them challenge market and regulatory orthodoxy.

We are unable to provide a detailed response on each of these complex issues given the unreasonably short consultation period. Therefore, FIN-USE wishes to focus on the following core areas.

1. A NEW REGULATORY AND SUPERVISORY ARCHITECTURE AT EU AND MEMBER STATE LEVEL

The international nature of financial markets and the recent financial crisis demonstrates how a narrow national approach to financial regulation is no longer effective. A new regulatory architecture is needed to prevent crises developing and coordinate interventions if a crisis occurs.
Moreover, to promote financial stability and manage systemic risk, the system of macro-prudential\(^3\) and micro-prudential\(^4\) regulation needs to be coordinated. A problem with an individual financial institution can very quickly be transformed into a systemic crisis.

Financial regulation failed to recognise that the total risk in the financial system was greater than the sum of the specific risks associated with individual financial institutions. Regulation failed to understand how vulnerable the system was to a withdrawal of wholesale funding which meant that a crisis of liquidity in the financial system turned into a solvency crisis for individual firms.

But the emphasis of financial regulation must be on customer and users protection. Macro-prudential and micro-prudential are only tools to guarantee stable, fair and transparent markets. The focus of the new system of financial regulation must be to guarantee the effective functioning of markets, providing trust and confidence to savers and users.

**Macro-prudential/ systemic regulation**

FIN-USE supports the De Larosiere Report’s recommendations on a new prudential financial architecture. A new European Financial Stability Agency (EFSA) should be established under the auspices of the European Central Bank (ECB). The overall objectives of EFSA should be to:

- promote financial stability at EU level; and
- improve the monitoring, prevention, management, and resolution of systemic financial crises at EU level.

However, setting up a stability and supervisory body (see EFRA below) under the auspice of ECB needs careful consideration on at least two aspects; 1) how to ensure that relevant micro prudential considerations are included in macroprudential assessments and regulation (and vice versa) and; 2) how to keep the macroprudential supervision on arms-lengths distance from ECB’s regular tasks and avoid conflicts of interests with the ECB’s monetary policy operations.

**Agency Governance**

\(^3\) Macro-prudential regulation relates to financial stability and systemic risk management

\(^4\) Micro-prudential regulation relates to the prudential regulation of individual financial institutions
The governing board of the agency should include lead representatives from the major EU authorities and agencies such as ministries of finance, central banks, and European Supervisory Authorities such as CEBS, CEIOPS, and CESR, and public interest representatives. However, to promote good governance and user confidence it is critical that a minimum number of seats on governing board should be reserved for user representatives. The existing consultative panel structure could be effective but it is no substitute for representation on the main governing board. The board should also reflect the changing nature of the EU economy with a minimum number of seats reserved for emerging EU economies.

Activities

The key activities of the EFSA should be to:
- monitor the financial system and identify systemic risks at EU level;
- issue risk warnings and guidance to national macro-prudential regulators;
- coordinate relationships between the relevant national macro-prudential regulators;
- coordinate working relationships with macro-prudential and micro-prudential regulators within the EU;
- coordinate responses to EU financial crises.

Micro-prudential/ financial institution regulation

Radical reform to the way individual financial institutions are regulated and supervised is equally important to restore confidence, protect consumers, promote financial stability, and prevent regulatory arbitrage. Financial markets can be vulnerable to group behaviour. Financial contagion can spread risk and the reckless behaviour of a handful of irresponsible financial institutions can trigger systemic crises.

Macro-prudential regulation needs to be put into effect through micro-prudential rules that control the behaviour of financial institutions, and set minimum standards to avoid regulatory arbitrage.

The work of macro-prudential and micro-prudential regulators and supervisors needs to be coordinated to be effective. There is a strong case for combining the macro and micro-prudential functions within the same organisation given the need for cooperation. However, we believe there is a stronger case for separating macro and micro regulatory
institutions, primarily in the interests of clarity and efficiency.

The distinction between regulation and supervision

Regulation sets standards of behaviour and rules. Supervision is the monitoring and enforcement of those rules by regulators. The system we propose is one where regulatory standards are set at EU level to promote consistency and prevent regulatory arbitrage, while the actual supervision of individual firms and enforcement of regulations is undertaken by national regulatory authorities.

Much of the regulation that is supposed to protect users in the EU’s member states is developed by EU institutions. These institutions also need to be reformed so that they play a role in regulating the behaviour of individual financial institutions in the EU.

A new single European Financial Regulatory Authority (EFRA) should be established to set prudential standards for EU financial institutions, act as coordinator-supervisor for larger EU wide financial institutions that represent systemic risk to the financial system of the EU, and set standards for valuing financial assets.

EFRA should consist of authorities that regulate specific types of financial institutions ie. banks, insurance companies and pension funds, asset management firms and securities firms, hedge funds and credit rating agencies. These specialised authorities should be created from the existing ‘level 3’ committees – CEBS, CEIOPS, and CESR. In the interim, these level 3 committees should be given more powers and authority to set robust, harmonised, minimum standards for prudential regulation of EU financial institutions. It is important that the shadow-banking system be regulated.

Authority Governance

The governing board of EFRA should include lead representatives from the major EU supervisory authorities such as CEBS, CEIOPS, and CESR, and public interest representatives. To promote good governance it is critical that a minimum number of seats on governing board should be reserved for user representatives. The board should also reflect the changing nature of the EU economy with a minimum number of seats reserved for emerging EU economies.
Activities

The key activities of EFRA should be to:

- coordinate and establish prudential standards for all financial institutions including banks, insurance companies, and hedge funds, and financial instruments such as securitised investment vehicles;
- oversee the monitoring of EU financial institutions;
- identify systemic risks caused by behaviour of financial institutions;
- issue risk warnings and guidance to national micro-prudential supervisors;
- coordinate relationships between the relevant national micro-prudential supervisors;
- coordinate working relationships with macro-prudential and micro-prudential regulators;
- coordinate responses to financial crisis with EFSA.

Member state level

EFRA should have authority to dictate to EU supervisory authorities the appropriate regulations and standards for financial institutions. The actual supervision of financial institutions and enforcement of regulations should be the responsibility of national supervisory authorities.

However, a critical question will be to find appropriate mechanisms 1) to ensure that precise and independent analyses and risk warnings can be prepared, and 2) that warnings can be transformed into effective policy responses.

Particularly complicating is the fact that warnings and recommendations will be decided at EU-level while correcting measures will have to be implemented (mostly) at national level.

To be able to undertake sharp analyses, warning and recommendations on basis of an EU-wide mandate the EFRA needs be sufficiently independent, as well as have an appropriate decision making structure. To further strengthen the compliance mechanism the work of EFRA should be subject to a high degree of transparency, preferably by public disclosure of analyses and recommendations (see also above under heading agency governance).

Client relations and investor protection regulation

As a medium term proposal, a new European Financial Users Authority (EFUA) could be established to protect
users of financial services and retail investors. Level 3 Committees, FIN-NET and FIN-USE must give the support to the European Commission on a study focus on the this new body.

The key activities of EFUA could be:

- regulation and supervision of retail/ conduct of business activities – this covers how firms treat consumers, efficiency of distribution, marketing and promotion, quality of advice and information provided to consumers, the behaviour of firms and intermediaries/advisers;
- coordination of redress – including financial institutions having efficient and fair procedures for handling complaints as well as consumers right to obtain redress if things go wrong;
- coordination of corporate governance and social responsibility of market participants.

2. FINANCIAL SERVICES USER REPRESENTATION

This next set of proposals relate to the critical issue of user representation at the heart of the regulatory system and the accountability of financial regulators. We will be publishing a separate paper soon on ‘Consumer Voice’. This paper will highlight how little direct influence EU user representatives have over policy formulation and regulation at EU and member state level. We have included a brief summary of our proposals on user representation in this submission – further details can be found in the forthcoming paper.

As part of the research for our Consumer Voice paper, we looked at the degree of user representation within the main EU regulatory institutions, and at member state level.

At member state level, there are very few members on the governing boards of the main financial regulators that FIN-USE considers to be dedicated public interest in sense of user representatives. For example, the clear majority of the members of the UK Financial Services Authority’s previous and current boards are from the financial services industry.

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5 Individuals who i) are currently working for user/ consumer organisation ii) had spent the majority of their recent career working for a user/ consumer organisation, or iii) are considered by user/ consumer representatives to be a dedicated user/ public interest representative.
Similarly, the French financial regulators’ “colleges” do not include any representatives of financial users\(^6\).

We analysed the level of user representation on the important ‘level 3’ committee consultative panels\(^7\).

*Committee of European Banking Supervisors (CEBS)*

The CEBS Consultative Panel has 21 members. Only three members have a user/ consumer representative background. CEBS currently has six expert groups. There appear to be no user/consumer representatives on these groups.

*Committee of European Securities Regulators (CESR)*

The CESR Consultative Panel has 17 members. Only one member has a user/ consumer representative background (the status of four members is not specified). CEBS appears to have 16 expert and operational groups. There appear to be no user/consumer representatives on these groups.

*Committee of European Insurance and Occupational Penions Supervisors (CEIOPS)*

The CEIOPS Consultative Panel has 17 members. Only one member has a user/ consumer representative background. CEIOPS has 11 working groups. It is not clear who the members of these groups are. However, we are not aware of any consumer/ user representatives being members of these groups.

Overall, of the 55 members on the three consultative panels, only five have a user representative background. We have to conclude that:

- users have very little opportunity to influence the work of the level 3 committees which play such an important role in policy formulation and regulation on financial services;
- this compounds the serious lack of consumer/ user-representation at national level and lack of resources available to user/ consumer representatives;

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\(^6\) There is one small exception: the AMF (the French Financial markets regulator) “college” does count one representative of “employee shareholders”, a very specific and minor kind of individual investors.

\(^7\) We based this research on information listed on the consultative panels websites.
• industry lobbies are over-represented. This must give the industry undue influence during the process of formulating, developing and implementing policy and introduce conflicts of interest on the regulators’ boards; and

• the level of under-representation is unacceptable and cannot be continued in the new regime that replaces the current level 3 committees. Comprehensive, new measures are needed to improve consumer/user representation at national and EU level.

It must be recognised that, as a fundamental issue of principle, there is simply no justification for financial regulators and policy makers refusing to have meaningful user representation at the highest decision making level given the importance of financial markets to society.

Moreover, the quality of decision making by regulators and policymakers would improve if it was subject to direct scrutiny by user representatives who would have the independence and objectivity to challenge market and regulatory orthodoxy.

Furthermore, a commitment to user representation promotes confidence in the system and allows policymakers and regulators to avoid the perceived and real risk of regulatory capture by powerful industry lobbies.

**Recommendations**

In our forthcoming paper on Consumer Voice, we make a series of recommendations to allow financial services users in EU member states to hold regulators to account and ensure their voice is heard during the policymaking process.

We focus here on recommendations to improve user representation at EU level.

These recommendations are intended to improve the functioning and accountability of the European Commission and of the important EU regulatory institutions – the important level 3 Committees (CEBS, CEIOPS, and CESR) outlined above.

It now seems that the intention is that the level 3 Committees will transform into powerful supervisory authorities for the banking, insurance and pensions, and securities/asset management sectors under the coordination of a single EU regulatory oversight authority.
Therefore, each of the recommendations we set out below should apply to the existing level 3 Committee structure and any subsequent structure that replaces it. Moreover, any EU regulatory oversight authority will need to have a governing board. As we set out above, to promote good governance it is critical that a minimum number of seats on the governing board should be reserved for user representatives.

**Recommendation 1**: each level 3 committee should ensure that at least one-third of the consultative panels are user representatives, and that these user-representatives should have sufficient resources to undertake their role effectively. If the de Larosiere report proposal to upgrade these committees into full-fledged European “Authorities” goes through, then, their governance bodies themselves should include financial users representatives.

**Recommendation 2**: each committee should ensure that the consultative panels have access to additional resources to support the work of consultative panels – including budgets for travel and other expenses to allow members to attend panel meetings. Panel members representing financial services users who are not fully employed and compensated by any other institution should be compensated for their work.

**Recommendation 3**: each committee should establish a consumer/user expert group. The role of the expert group should be to: provide insight to level 3 committees on the impact of consultations and initiatives on consumers/users; ensure the Lamfalussy process is taking consumer/user interests into account; ensure any consultation process factors in the consumer/user interest. Expert Group members representing financial services users who are not fully employed and compensated by any other institution should be compensated for their work.

**Recommendation 4**: each committee should appoint a consumer coordinator to support the work of the consumer/expert standing committee and coordinate relationships with consumer/user organisations.

**Recommendation 5**: the EC should properly resource FIN-USE as its user expert forum.

**Recommendation 6**: the EC should help fund the representation of financial services users at the European level, to address the huge imbalance of resources between users and the financial industries in terms of European lobbying, and enable financial users to make their voice
heard at the European level. We note with interest that the Commission has included reference to funding investor-stakeholders in the recent Communication. While we recognise and support the need to improve the capacity of investor-stakeholders, who are amongst the first and direct victims of the financial crisis, it is critical that these resources should not be restricted to these groups. For example, it appears that this would then exclude supporting users such as overindebted consumers or financially excluded groups who are also unintended victims of the financial crisis.

3. A NEW APPROACH TO FINANCIAL REGULATION, SUPERVISION AND ENFORCEMENT

Just as the structure of financial regulation needs reforming, FIN-USE argues that a new coherent, consistent, robust approach to financial regulation, supervision and enforcement (including risk management) is needed to:

- protect customers and users of financial services
- ensure stability of the financial system;
- restore confidence in the financial system;
- reduce the risk of a similar crisis recurring;
- enforce effective governance and accountability in the financial industry; and
- ensure financial markets operate in the interests of users and wider society.

Some of the flaws that allowed the financial crisis to occur only became evident with hindsight. However, some user representatives have been warning for some time that the approach to financial regulation followed by regulators was not sufficiently robust, consistent or comprehensive to cope with the challenges presented by modern, international financial markets.

FIN-USE has already set out detailed recommendations on how to improve the regulation of financial markets in its Opinion on reforming mortgage credit markets8, and response to the Green Paper on Financial Services9.

Therefore, we will include here just a brief summary of those recommendations (details of how these recommendations can be implemented can be found in the other responses).

Risk management

Many of the recommendations we have already made to the EC in our previous submissions relate to the more effective management of risk. The key areas that need addressing include:

- contra-cyclical capital requirements to control asset price bubbles and manage systemic risk;
- risk management at macro-prudential and micro-prudential level;
- improved liquidity risk management;
- internal risk controls and data sharing within individual financial institutions;
- treatment, consolidation and integrity of balance sheet assets (especially off-balance sheet assets);
- pricing and trading transparency;
- accounting standards (consistency and transparency is necessary to restore confidence in balance sheets and valuations);
- role of information intermediaries including ratings agencies, auditors and actuaries;
- monitoring and enforcement of regulation;
- the distorting role of aggressive remuneration strategies that encourage reckless risk taking and introduce conflicts of interest between the various parties in the financial system (including financial institutions, intermediaries and end-users).

Principles-based regulation

One of the key areas that must be addressed is the failure of principles based regulation.

Perhaps not surprisingly, given the different structure of capital markets and lending institutions around the world and the fast-moving nature of financial markets, regulatory authorities at international, EU and national level lending institutions moved towards a principles-based approach to prudential regulation.

But, in an increasingly globalised and complex financial world, consumer advocates constantly warn about the risk of ‘regulatory arbitrage’ where market participants attempt to shift their activities to jurisdictions or financial institutions that are less regulated and transparent, or to less well
regulated or transparent financial mechanisms such as off-balance sheet vehicles, securitised investment vehicles (SIVs) and so on. Therefore, the regulatory framework will need to ensure that it does not encourage regulatory arbitrage and policymakers need to adopt consistent, robust regulation.

It is now clear that the new BASEL II regime or principles-based regulation which became fashionable amongst regulators is not fit-for-purpose for managing risks in the markets.

Principles based regulation is meant to be more flexible and better suited to dealing with fast moving and innovative financial markets. But principles based regulation doesn’t work without effective governance and accountability mechanisms to manage the conflicts of interests inherent in the financial system.

The financial crisis has cast doubt on the credibility of banks’ internal governance and risk assessment and management systems and the role of credit rating agencies in externally assessing the risk of complex structured products. Equally, the capacity of regulators to monitor the risky, multifaceted activities of large cross-border institutions has been subjected to immense stress.

In addressing these issues, FIN-USE argues for a regulatory paradigm shift, which resets the incentives to establish an integrated risk-assessment, -management and -governance culture at an institution-wide level. Towards this end, it stresses the need to strengthen the roles of pillars 2 and 3 (supervisory review and market discipline) and to avoid relying solely on the outcome of easily manipulated, excessively sophisticated internal models to determine capital requirements and a supervisory ‘box-ticking’ approach.

**Improving governance and management of conflicts of interest**

Another issue we would highlight from a user-perspective are the various conflicts of interest that exist along the financial services supply chain. We think these conflicts have been a key cause of the current financial crisis and have encouraged undue risk taking and irresponsible lending. These conflicts include:

- at the point of sale, the use of commission and aggressive remuneration practices mean that sales staff and intermediaries face a conflict between
making a sale and offering investors and borrowers appropriate advice;

- aggressive bonus payments which reward employees for taking excessive risks – this provides incentives for employees to take undue risks but also conceal exposures or loss making positions;
- conflicts of interest between non-executive directors and executive directors/ senior management;
- financial conflicts between lenders, investors and supposedly objective third parties such as credit rating agencies.

If risks are to be managed effectively in future then more needs to be done to regulate the relationships between the various parties in the market. Each of these major conflicts of interest needs to be addressed, and the interests of market participants better aligned, by policy interventions and targeted regulations.

FIN-USE recommends that specific new regulatory measures be introduced to deal with remuneration policies that encourage reckless behaviour or introduce conflicts of interest.

Transparency, enforcement and sanctions

Regulators at EU and national level must become more transparent, robust and act as agents of society to ensure that financial institutions behave appropriately and with integrity. To do this, FIN-USE recommends that regulatory authorities introduce a new, robust system of sanctions. We recommend that supervisors should be given the power to fine firms who breach financial regulations up to 30% of annual turnover.

Consistent and coherent regulation

If we are to avoid regulatory arbitrage, promote confidence, and create a level playing field for the financial services industry, these new robust regulatory standards must apply to all financial institutions, products and jurisdictions.

Clearly, effective regulation of the shadow banking system and alternative financial products such as hedge funds and private equities which has undermined transparency in markets must be a priority.

However, a new coherent approach must be applied to retail financial services regulation as well. We need to move away from the ‘silo-approach’ which regulates products and firms
according to their legal and corporate structure to one which regulates according to users needs. We recommend therefore that the EC use this opportunity to instigate a wide ranging harmonisation of retail market regulation ensuring that these regulations conform to robust minimum standards.

Moreover, now is the appropriate time to review the structure and application of deposit, insurance, and pension protection schemes to ensure EU financial users benefit from a coherent protection system. This will be crucial to support the implementation of a functioning single EU market.

4. GOVERNANCE OF FINANCIAL INSTITUTIONS AND THE ROLE OF LONG TERM INVESTORS

There has been much discussion recently about the underlying causes of the financial crisis. However, we think the failure of governance in financial institutions and role of long term investors has been underplayed somewhat. A series of measures are needed to improve financial governance and ensure that ordinary citizen-investors and their representatives (such as pension fund trustees) are able to exercise due diligence and responsible influence over the behaviour of financial institutions.

Investor due diligence

It should be remembered that one of the major sources of wholesale funding for mortgages has been institutional investors (such as pension funds and insurance companies). However, the quality of the due diligence undertaken by institutional investors to understand the risks involved has been questionable.

Of course, this has not been helped by the lack of transparency in the markets and the role of credit rating agencies. Nevertheless, institutional investors ought to have been more alert to the risks involved and paid more attention to the quality of mortgage books underpinning securitised assets.

The EC has understandably begun to look at the role it can play in improving financial capability of retail financial consumers. However, the crisis in the wholesale financial markets and the role of institutional investors suggests to FIN-USE that policymakers should undertake similar initiatives to improve the knowledge and capability of institutional investors (such as pension fund trustees).
Corporate governance and the role of non-executive directors

As we highlight above, the failure of lenders’ internal models to assess and control risks, and weak governance structures that incentivised key individuals along the supply chain to behave recklessly contributed to reckless lending in the market.

The role of board directors and non-executive directors in providing the checks and balances to control the behavior of senior management must be questioned. Non-executives in particular are supposed to provide the independent oversight of executive director and senior management behaviour on behalf of shareholders.

But there are concerns that non-excecutives directors either:

- did not understand the risks involved or the new lines of business firms became involved in;
- if they did understand what was going on, did not feel empowered or confident enough to challenge executive decisions;
- alternatively, non-executives may not have been provided with the appropriate level of information to understand risks and exercise due diligence.
- Lastly one can question their independence vis-à-vis the management (see for example the Lehman Brothers case, where the Board approved $ billions of performance-based bonuses to the management, and the bank went bankrupt a few months later, ruining non insider shareholders).

In line with our recommendation on improving capability of institutional investors, we urge policymakers to review and improve the corporate governance structures of banks and other lenders and improve the independence, training and competence of non-executive directors.

Recommendations

- Governance of critical financial institutions must be improved. Public banks should introduce public interest representatives to main boards. Regulators should ensure that non-executive directors (NEDs) play a more active role in managing institutional risk and have the independence and ability to provide additional objective oversight of operations.
• Pension scheme governance must be enhanced by increasing the number of employee/pension member representatives on trustee boards.
• Substantial resources should be provided to improve the training and competence of financial user representatives (including pension fund trustees) so that they can exercise greater due diligence and responsible influence on the behaviour of financial institutions on behalf of citizen-owners.
• New regulations are needed to control the activities of intermediaries such as pension fund consultants, investment managers, actuaries and advisers to ensure independence and objectivity and control conflicts of interest. As a first step, there should be a review of the role of these agents in the crisis.
• Statutory disclosure of corporate governance information is needed to ensure pension scheme trustees and citizen-owners can exercise greater, more responsible influence over financial markets. This information should be independently audited.

This marks the end of FIN-USE’s submission

April 2009