Reforms in the Financial Sector – How to Restore Confidence?

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KNUTE Roundtable

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Agenda

- Introduction
- Objectives of Financial Regulation
- The Nature of Investor Protection
- AIFMD and Beyond
- Outlook

Introduction (1)

- **EU-Ukraine Association Agreement (AA) (I)**
  - *„Provisions for domestic regulation, postal and courier services, financial services and telecommunication services will improve transparency and legal certainty for EU investments in Ukraine. The focus here is on "behind the border" issues. "*

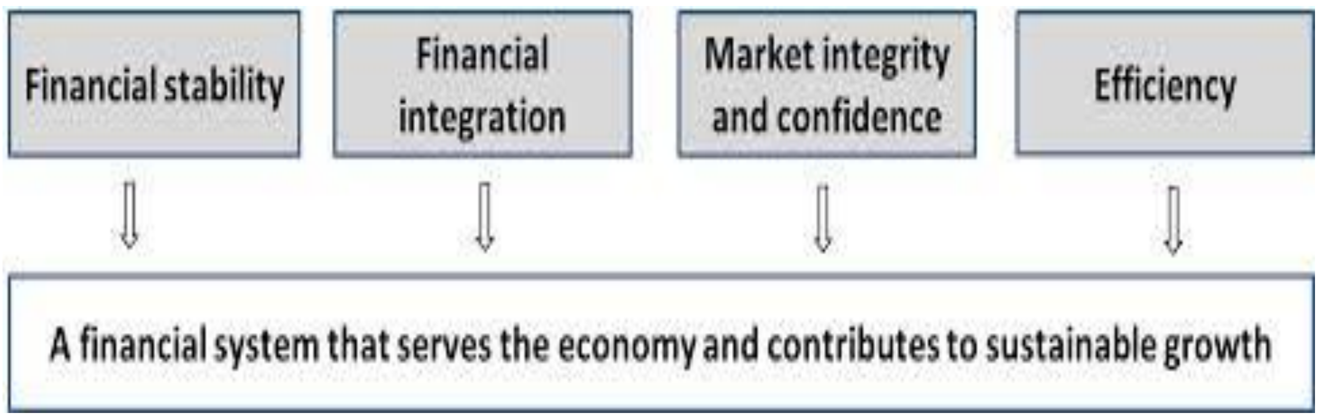
  - *"The DCFTA is complemented by a process of legislative approximation in financial services, telecommunications services, postal and courier services, and international maritime services. The* ***Ukraine is committed to take over the existing and future EU-acquis*** *in those sectors and, when it has done so, Ukrainian firms will be granted access to the EU internal market for the sectors concerned: this is an <u>unprecedented level of integration</u>. The approximation process will also mean that* ***<u>EU investors in those sectors will find the same regulatory environment in Ukraine as in the EU</u>****."*

Objectives of Financial Regulation

Objectives of Financial Regulation (I)

- **Objectives of Financial Regulation in General**
  - objectives have <u>multiple dimensions</u>:
    - **<u>transactional protection for market participants</u>**
      - transparency
      - legal certainty
      - information
      - investor protection
    - **<u>maintenance of robustness and integrity of the system</u>**
      - financial stability
      - legal certainty
      - macro- and micro-prudential aspects
    - **<u>supranational dimension (EU)</u>**

Objectives of Financial Regulation (II)



Source: European Commission

Objectives of Financial Regulation (III)

- **Financial Stability As Key Aspect of Financial Regulation (I)**
  - **Financial Stability:**

"Financial stability is difficult to define and even more difficult to measure. Strictly speaking, a financial system can be characterised as stable in the absence of excessive volatility, stressor crises. This narrow definition is relatively simple to formulate, but fails to capture the positive contribution of a well-functioning financial system to overall economic performance. Indeed, broader definitions of financial stability encompass the smooth functioning of a complex nexus of relationships among financial markets, infrastructures and institutions operating within the given legal, fiscal and accounting frameworks. Such definitions are more abstract but are more inclusive of the macro-economic dimension of financial stability and interactions between the financial and real sectors. From this perspective, financial stability can be defined as "a condition in which the financial system – comprising financial intermediaries, markets and market infrastructure – is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities." **ECB** (2007)

Objectives of Financial Regulation (IV)

- **Financial Stability as Key Aspect of Financial Regulation(II)**
  - public good?
  - financial stability as trigger for the establishment of BIS
    - Basel Capital Accord
  - financial stability as objective for regulators
    - FSA / FCA
    - FMA
    - see also ECB, Federal Reserve and central banks
    - challenge of regulatory arbitrage
  - financial stability as political dogma
  - combination of macro- and micro-prudential regulation as answer?

Objectives of Financial Regulation (V)

- **Transactional Protections (I)**

  - <u>transactional protections as result of government intervention</u>
    - information asymmetry
    - agency problems
    - attempt to ensure market discipline
    - create level-playing fields
    - enhancing the efficiency of the market

  - <u>key tenets</u>:
    - securities disclosure regulation
    - principal-agent-relationship between financial intermediaries and clients

Objectives of Financial Regulation (VI)

- **Transactional Protections (II)**
  - Securities Disclosure Regulation
    - mandatory disclosure in order to tackle information asymmetries
      - securities
      - collective investment schemes
    - effectiveness of voluntary disclosure questionable?
    - delivering "material information" to take an informed investment decision
    - challenge: complexity of financial products (appropriateness, suitability)
    - new dimension: disclosure requirements for
      - credit rating agencies (CRA)
      - benchmarks
      - hedge funds and private equity funds

Objectives of Financial Regulation (VII)

- **Transactional Protections (III)**
  - <u>Principal-Agent Problem of Financial Intermediaries</u>
    - specific economic roles of financial intermediaries and regulatory attention
    - <u>services</u>: order execution, investment advice, portfolio management
    - <u>challenge</u>: superior knowledge of intermediaries and strengthening of client's trust
    - <u>example</u>: MiFID (WAG 2007) → MiFID II (2017?)

Objectives of Financial Regulation (VIII)

- **Financial Stability (I)**
  - Financial Stability means:
    - “**addressing vulnerabilities affecting financial systems**”
    - balancing risks in the system
    - addressing the risk allocation role of the financial sector (finance versus real economy)
    - increased regulatory focus on risk-management at micro- as well as marco-level
    - establishing systems to detect vulnerabilities affecting the financial systems and ensuring possibilities tools for early intervention and warning mechanisms

Objectives of Financial Regulation (IX)

- **Financial Stability (II)**
  - <u>"New" Concept of Systemic Risk (I):</u>
    - developing concept
    - attempt to define as follows: *"(i) the <u>amount of risk that the financial system takes at a point in time relative to its capital and liquidity resources</u> ('time-varying' or 'cyclical' risk); and (ii) for a given amount of time-varying risk, structural features of the financial system, such as its connections and the <u>distribution of risk across different participants, which create exacerbate vulnerabilities</u> ('cross-sectional' or 'structural' risk"* **Bank of England and FSA** (2011)
    - contagious effect of institutional failure leading to "<u>real contagion</u>"
    - systemic risk leading to "collective welfare failure"?

Objectives of Financial Regulation (X)

- **Financial Stability (III)**
  - “New” Concept of Systemic Risk (II):
    - regulatory action: “Systemically Important Financial Institutions” (**SIFIs**)
      - EU approach
      - US approach
      - common features: a) size, b) linkages, c) global footprint, d) complexity and e) substitutability of services
      - special regulatory monitoring: a) extra capital charges, b) stress tests, c) recovery plans, d) institutional divisions of business units

Objectives of Financial Regulation (XI)

- **Interplay with Economic Policy and Monetary Policy**
  - correlation between loose monetary policy and excessive levels of risk-taking? (US phenomenon?)
  - role of ECB
    - SSM
    - SIFIs
  - central banks:
    - banking supervision to the detriment of keeping inflation low?
    - bank supervision useful to monetary policy?
    - focus on price stability at the expense of wider contribution to financial stability?
    - financial crisis led to a convergence of these concepts

The Nature of Investor Protection

The Nature of Investor Protection (I)

- **General Observations**
  - Investor Protection as <u>principle in financial regulation</u>
    - <u>economic rationale – transaction-oriented measures</u>
      - wholesale market (professional segment)
      - retail market
    - <u>investor protection as means of financial stability</u>
      - losses in investor assets and wealth → loss to consumption and investment economies
      - losses by financial institutions as investors and intermediaries → losses as credit and investment shrink
      - losses to real economy
    - <u>Who is the “investor”?</u>
      - intermediaries as investors (sophisticated individuals, corporations, institutional investors, CIS)
      - retail segment (as common denominator?)
      - paternalism

The Nature of Investor Protection (II)

- **Observations**
  - “poster boy for financial regulation”?
  - regulatory intervention in consumer protection as attractive policy option
    - ideology
    - renewed strands of paternalism
      - libertarian
  - financial education as corresponding feature?
  - focus on distribution aspects
    - interaction with consumer
    - different approaches: RDR vs. continental approaches
  - concept of paternalism

The Nature of Investor Protection (III)

- **Justifying Paternalism in Consumer Protection (I)**

  - <u>choices made by bureaucrats</u>
    - better choices than consumers?
    - human beings with different cognitive biases and limitations
    - bureaucrats in charge of governance will not necessarily make better welfare choices than individuals
    - <u>consider</u>: Austrian School of Economics (i.e. Ludwig von Mises, Hayek, etc.)
    - change if choices made by bureaucrats with input from external consultants?

  - <u>timing of paternalistic intervention</u>
    - “short-term” intervention
    - “long-term” bottom-up learning

  - <u>increased paternalism entailing moral hazard?</u>
    - “long-term” aspect?
    - poorer level of information in the market, decline in quality of advice, lack of motivation of consumers
    - tool to overcome weaknesses in consumer markets

The Nature of Investor Protection (IV)

- **Justifying Paternalism in Consumer Protection (II)**
  - <u>accountability of regulator</u>
    - accountability linked to rise in paternalistic actions
    - accountability and regulatory architecture
  - <u>reasons for paternalistic interventions:</u>
    - perceived inadequacy of disclosure-based regulation
    - consumer behaviour not always rational
    - empirically-proven lack of consumer market discipline for product providers and distribution conduct
    - leads to rationale of market failure
  - <u>debate about usefulness of disclosure</u>
    - user discipline in market only effective to support disclosure regulation, if information is ‘embedded’ in decision-making process
    - consumers inundated with the massive quantity of mandatory disclosure
    - delivering of mandatory disclosure not sufficient
    - consumers do not read information provided; risk warnings downplayed
    - mismatch between consumer needs and regulatory framework

The Nature of Investor Protection (V)

- **Justifying Paternalism in Consumer Protection (IV)**

  - <u>difficulties exercising consumer powers</u>
    - market competition
    - challenges at pre-contractual stage: inequality of bargaining power and sophistication
    - role of trust of professionals
    - challenges at post-sale stage: product does not match needs

  - <u>Intervention measures:</u>
    - disclosure
    - cooling-off periods
    - prohibitions in terms of financial promotion
    - advisor regulation
    - client categorization
    - signing of protocol
    - etc.

  - <u>consumer claims</u>
    - lack of credible, unexploitative collective avenues

AIFMD and Beyond

The Alternative Investment Fund Manager Directive

AIFMD (1)

- **Rationale for Regulation (I)**

  - Formal Aspects (I)
    - Trigger: GFC

    - G-20 summit in London (April 2, 2009)
    - Lehman Brothers; AIG; hedge funds as "locusts"; new dogma of systemic risk
    - EC publishes draft regulation on April 30, 2009

    - challenge: draft regulation itself
    - needed: **3** Council Presidencies, **1** Rapporteur, > **1600** amendments
    - agreement in trilogues on October 27, 2010

AIFMD (2)

- **Rationale for Regulation (II)**
  - Formal Aspects (II)
    - compromise:

Date	Status /Review Process
X (2011)	entry into force and publication
X + 4 (2015)	review process: - ESMA - European Commission
X + 7 (**2018**)	full implementation (including third country regime and PP regimes)

AIFMD (3)

- **Rationale for Regulation (III)**
  - Material Aspects (I)
    - De Larosiére Report calls for inclusion of shadow banking system
    - EC: "alternative investment funds *could* generate systemic risk in the future"
      - connection to other financial institutions
      - trading activities
      - investment strategies including short-selling (see Regulation (EU) No. 236/2012 on Short-Selling and Certain Aspects of CDS)
      - potential investor losses
      - also market failures in investor and stakeholder protection

AIFMD (4)

- **Rationale for Regulation (IV)**
  - Material Aspects (II)
    - structure of AIFMD framework is:
      - **manager directive** (versus product directive)
      - **AIFM is in regulatory scope not the product (AIF)**

AIFMD (5)

- **Scope of AIFMD (I)**
  - Principles
    - *everything that is **non-UCITS** is AIF and therefore in scope*
      - no differentiation between open-ended or closed-ended
      - no differentiation in terms of legal form
      - no differentiation if traded on stock exchange, the amount of capital or number of investors
    - *framework is targeting **institutional** investors*
      - unlike UCITS
    - *introduction of a "**European Passport**"*

AIFMD (6)

- **Scope of AIFMD (II)**
  - Main Applications of AIFMD
    - all **EU-AIFM** that manage one or more **EU-AIF** or **Non-EU-AIF**
    - all **Non-EU-AIFM** that manage **EU-AIF**, no matter if they are distributed in the EU
    - all **Non-EU-AIFM** that distribute either **EU-AIF** or **Non-EU-AIF** within the EU
  - **Exemptions:** holding companies, IORP institutions and institutions in the area of social insurance and pension systems
  - **quantitative thresholds** can be applied leading to **“registrations”**
  - **UCITS companies** have certain privileges

AIFMD (7)

- **Aspects of Prudential and Risk Management Regulation (I)**

  - **Capital Adequacy**
    - CA requirements imposed in respect of initial capital, own funds and additional own funds
    - differentiation if AIF is internally or externally managed

  - **Organizational and Risk Management Requirements**
    - regulatory focus on risk management (also from a prudential perspective)
    - organizational structure for risk management (see MiFID requirements) with reporting requirements
    - greater operational responsibilities, also in terms of internal control mechanisms

AIFMD (8)

- **Aspects of Prudential and Risk Management Regulation (II)**

  - **Liquidity Management**
    - requirement of liquidity management systems for AIFM
    - requirement of liquidity buffers to mitigate risks

  - **Remuneration Policies**
    - AIFM is required to establish remuneration policies and practices that are consistent with an effective risk management
    - CRD III serves as basis
    - broad application to senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of the managed AIFs

AIFMD (9)

- **Aspects of Prudential and Risk Management Regulation (III)**

  - **Restrictions on Investments and Investment Strategies**
    - „pre-approval“ of applied investment strategies
    - imposition of „short-selling“-restrictions
    - reduction of leverage in case of private funds in particular
    - restrictions in terms of investments in productswhich do not reflect at least 5% net economic interest in the underlying securities or FI

  - **Outsourcing and Delegation**
    - approval of outsourcing arrangements
    - outsourcing(/delegation only to eligible entities
    - application of the concept of „functional and hierarchical separation“ of entities
    - requirements for sub-delegations and liabiliy regimes

AIFMD (10)

- **Aspects of Prudential and Risk Management Regulation (IV)**
  - **Regulatory Reporting**
    - reporting obligations at AIFM and AIF level
    - standardized format and technical infrastructure
    - domestic to supranational level
  - **Investor and Stakeholder Protection**
    - duties in fund management (such as DD, care, effective resources, etc)
    - management of conflicts of interest (see MiFID)
    - separation of depositaries
    - valuation methods to be applied and approved valuation procedures
    - disclosure requirements (see UCITS analogy)
    - specific PE acquisition rules regarding non-listed companies

Beyond AIFMD

Beyond AIFMD (1)

- **UCITS Directive**
  - Directive 2014/91/EU (**UCITS V**)
    - EU (retail) investment fund regulation since 1985
    - classic product regulation
    - continuous regulatory development (UCITS I → UCITS V)
    - rules about:
      - organisational requirements (management company, depositary)
      - product features
      - transparency (AR, Prospectus, KID) etc.

Beyond AIFMD (2)

- **Capital Requirements Directive (CRD) + CRR**
  - **EU banking regulation**
    - derived from Basel framework
    - indirect effects on capital markets
      - capital ratios
      - remuneration
      - regulatory reporting
      - risk assessment mechanisms

Beyond AIFMD (3)

- **Markets in Financial Instruments Directive (MiFID) II and MiFIR**
  - <u>horizontal legislation (intended level-playing field with *IMD*)</u>, covering
    - intends to harmonize the relationships between investment firms and clients and product distribution
    - client categorizations as main pillars
    - material nexus to the *Packaged Retail Investment and Insurance-based Products (PRIIPs)* initiative
      - definition of target market
      - categorization of financial instruments
    - rules on the complexity of financial instruments
    - rules on the execution of orders etc
    - impacts technical infrastructure (i.e. telephone recordings etc)

Beyond AIFMD (4)

- **Solvency II**
  - “CRD-regulation” for insurance companies
  - solvency II regulatory framework is primarily targeted at insurance companies
    - complexity (also in terms of technicalities) comparable to CRD
    - indirect consequences on capital market players in terms of consistency and coherence

Outlook

Outlook (1)

- **reconsidering that financial regulation shall serve as a framework**
  - ad hoc reactions may be necessary but carefully calibrated (a regulator is not „Robin Hood“)
  - calibration of macro- and micro-prudential necessities
  - financial regulation as a framework is not purely domestic in scope, preferably supra-national
  - financial regulation is a two-sided coin (see constitutions of domestic regulators)
  - current regulatory environment is fragmented

Outlook (2)

- **any „sprinkler system“ of financial regulation needs to be rejected**

  - control panel: cost & benefit analysis
  - timing of regulation is crucial but speed often kills
  - issuing regulation with (full) implementation periods of more than three years needs to be rejected
  - regulation without regulatory infrastructure needs to be rejected
  - quality characteristics of financial regulation necessary (see pro- versus counter-cyclicality)

Thank you very much for your attention!

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