TACD

TRANS ATLANTIC CONSUMER DIALOGUE

DIALOGUE TRANSATLANTIQUE DES CONSOMMATEURS

DOC No: FINANCE 01-09 DATE ISSUED: June 2009

Resolution on Financial Services Regulation

Introduction

The European Union and the United States are currently faced with the greatest economic crisis we have seen since the Great Depression. Failing banks, mountainous debt, little consumer savings, falling home values, unprecedented repossessions and foreclosures, increasing unemployment rates and the resulting deterioration of our education, health and social security systems threaten our countries' immediate and long-term financial well-being. How we respond to this failure and the lessons we learn from allowing this crisis to happen, will go a long way to determining whether the EU and the US can regulate the financial services industry to avoid further economic devastation.

As an organization dedicated to protecting the interests of consumers and the global consumer marketplace, TACD was not surprised by the current economic crisis. It has been clear to us, for more than the past decade, that our nations' regulatory systems could not and were unwilling to effectively require big financial institutions to properly manage risk, did not and were unwilling to require sufficient transparency in financial institutions' deal making and corporate accounting, and did little if anything to ensure that these institutions dealt fairly with consumers or their investors.

What should be clear to everyone by now is that, left unchecked, financial markets are inherently inefficient and prone to great extremes. The system proved to be pro-cyclical: magnifying the boom and the subsequent bust. The provision of credit has moved from feast to famine, with consumers suffering the consequences. Governments must play the critical role of guiding market behavior so that both public and private risk is properly managed. Simply, without clear and effective rules in place and enforced, productive financial activity can and will degenerate into reckless gambling, while sophisticated financial transactions, as well as more ordinary consumer credit transactions will be subject to widespread cheating and fraud.

CONSUMER PROTECTION MUST BE A CENTRAL COMPONENT OF REGULATING FINANCIAL SERVICES

The crucial lesson we must take away from the current economic crisis is that strong consumer protection regulation is essential not only to the protection of the financial consumer interests but also to the safety and soundness of our nations' financial systems. The breakdown of our economies was instigated by the dishonest and unfair consumer lending practices of the worlds' largest financial institutions. The loans these multi-national companies created and funded with ridiculously complex and opaque financial instruments were negligibly underwritten; unsuitable and unsustainable for borrowers; arranged by persons not bound to act in the best interest of the borrower; and with terms so complex and arcane that many individual consumers had little opportunity or capacity to fully understand the nature or magnitude of the risks of these loans. If our governments had provided effective consumer protections that would have truly punished institutions engaged in these practices, much of our current economic disaster could have been averted. Unfortunately they did not and unfair and deceptive practices prospered. When financial institutions do a cost-benefit analysis of regulation and determine that unfair and deceptive practices will go unpunished, but instead be rewarded, then those practices will ultimately become standard industry practice. Regulation and enforcement must be strong, widespread and sufficient to guide financial institutions to choose behaviors that reward them for developing good products and treating their customers fairly. Remuneration structures at all levels within a financial institution, from Board level to those dealing with customers on a day-to-day basis, must be aligned with the fair treatment of customers. If Directors and staff are clear that failing to treat customers fairly or breaching regulations will diminish or eliminate their personal reward packages, then they will all have a real incentive to ensure that their company meets required standards and exercises proper oversight.

In developing these regulation and enforcement schemes, all levels of governments must participate in the development of consumer protection regulation. On the international level, because much of the financial services industry operates cross-border, these companies must be monitored trans-nationally by regulators and enforcement officials – as their behavior carries risks into every market in which they do business. Additionally, while it is important that we create a floor of international standards to govern global financial service industry behavior, these standards (and the desire of industry for international harmonization) must not stymie early action or stronger standards by individual jurisdictions. Conversely, it is equally essential that international regulators not allow these institutions to avoid one country's stricter regulation by "exporting" their home countries more lax regulation, thus leading to a competitive race to the bottom among countries seeking to attract corporate headquarters.

On the national level, where much of the regulatory failure has occurred, consumer protection law must be seen as an essential part of creating a robust and sustainable consumer marketplace and economy. Simply, for our economies to function properly, the financial services market must be built and structured from the consumer perspective. Transparency, responsible behaviour of providers, effective consumer rights, easy access to neutral advice, strong redress mechanisms and sufficient consumer consultation rights must be built into a well-managed and well-regulated financial services structure.

Finally, in developing these viable and effective consumer protection schemes, national governments in the US and the EU and EU institutions in Europe must allow for a strong concurrent and complementary role for local, national or transnational government regulators. These more local governments can provide needed early enforcement of existing standards and also develop new standards to address emerging practices before they cause widespread consumer harm or systemic risk. National and local legislatures are often in a unique position to spot and stop bad practices before they become universal. To ensure rapid and appropriate responses to abuses in the financial credit markets, consumer protection and regulation of financial institutions must be allowed at all levels of government.

TACD RECOMMENDATIONS

1. **Strong consumer protection regulations must be developed and enforced to ensure the safety and soundness of the international financial system.** In developing strong regulations, the E.U. and the U.S. should: (1) create prudential rules that define responsible behavior for financial services institutions; (2) make certain that provided consumer information is short, structured and focused on the key features of product and contract; (3) facilitate easy access to neutral advice (4) significantly strengthen the liability of and sanctions for corporate misbehavior towards consumer and the general markets; (5) strengthen and allow for public and private enforcement, including collective redress, of these rules and regulations; (6) support capacity building for consumer advocacy organizations and (7) increase consumer representation on the Boards of financial regulators and financial supervisors. In the E.U. these regulations should allow for meaningful consumer representation and consultation on the European level, especially with the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR).

2. **A strong concurrent and complementary role for local or national governments can provide needed early enforcement of existing standards and also develop new standards to address emerging practices before they cause widespread consumer harm or systemic risk.** National and local legislatures are often in a unique position to spot and stop bad practices before they become universal. Over the past decades, local and state attempts in the U.S. to stop bad financial mortgage and credit practices have been thwarted by overreaching and bank captured U.S. Treasury Department bureaus known as the Office of the Comptroller of the Currency and the Office of Thrift Supervision. To ensure rapid and appropriate responses to abuses in the financial credit markets, consumer protection and regulation of financial institutions must be allowed at all levels of government. In the European Union, the policy to harmonize legislation related to consumers as much as possible must be changed. While E.U. harmonization policies were aimed at granting providers easy access to all markets, these policies failed to sufficiently take into consideration the interests and needs of consumers. While competition for the most efficient consumer protection standards can be allowed, we cannot permit this competition to devolve into a race to provide minimal regulation and consumer protection standards.

3. **Before a new loan product or a new investment product is introduced into the marketplace, an agency, whose sole mission would be to determine a credit product's safety, should evaluate its appropriateness for wide, limited or no distribution.** It may be also necessary to label products belonging to certain risk categories, to give consumers time to reconsider whether they wish to purchase riskier products. We fully support the G20's statement that no market, no product, no financial services provider shall be without regulation and supervision. In the E.U. and the U.S. we support an independent consumer financial product safety commission that includes consumer attorneys and lay advocates and is responsible for evaluating and approving credit products before they are allowed in the marketplace. In making this evaluation, the regulatory agency should require that the complexity of financial products be reduced to better match the nature and purposes of the intended user of those products.

4. **Governments should never abdicate their responsibility in protecting consumers and the marketplace from unfair and deceptive practices, by merely relying on the failed practice of "consumer choice" through disclosures.** In a complex world, filled with complicated and confusing financial credit instruments, regulation by "disclosure" cannot be a substitute for real, substantive regulation. Disclosures can play a complementary role to strong regulation and when disclosures are offered to consumers (to avoid information overload) they should focus on the key features of the product and contract in a short, structured and universally comparable format. Moreover, enforcement bodies should fulfill the following functions: participate in advertising control, control of financial information, unfair practices, distribution of financial products (for example in the area of consumer credit); take charge of an early warning system (inform consumers about the risks/risk category of various financial products on the basis of continuous enquiries).

5. **Credit regulation must promote responsible lending practices by rewarding all the actors in the industry when loans succeed (over a significant period of time) and force them to take responsibility (and loss) when those loans fail.** For the financial credit industry to produce loans that are fair, appropriate and sustainable, the rules of the credit marketplace must be changed. Rules must be developed so that all the financial service industry actors involved in creating loans (from the sales person to the investment bank) are held accountable. In the U.S., this regulation must allow for full assignee liability, so that the borrower can seek redress against any entity that winds up owning an interest in their loan. Furthermore, responsible practices must be required through the full life-cycle of the loan and the increasing number of consumers in financial difficulty must be treated fairly. Repossession / foreclosure should be a last resort and consumers must be offered the flexibility to restructure their mortgages wherever possible to enable them to remain in their homes. Moreover, if the lender's decision is based on a poor quality assessment of consumer's financial situation, the costs of irresponsible lending should be borne only by lenders and not by consumers.

6. **Credit Rating Agencies must be strictly regulated**. Some of the failures we are seeing in our global financial institutions could have been avoided, had the private credit ratings agencies done real due diligence and provided better, more accurate credit ratings. If companies issuing high-risk credit instruments had not been able to obtain AAA ratings from the private credit rating agencies, then pension funds, financial institutions, state and local municipalities, and others that relied on those ratings would not have been misled into making dangerous investments. Credit Rating agencies, like Standard and Poors, Moody's, and Fitch, despite their claims as neutral arbiters, were corrupted by their fee structure, their relationships with the investment banks whose bonds they were supposed to judge, and the opportunity to make vast sums of money rating complex structured products whose risks they did not fully comprehend. European regulations that demand transparency, independence, diversity and real liability, including strong sanctions for misleading consumers and investors, should be strictly required before these agencies are allowed to rate securities, as should similar ideas being developed in the United States to improve regulatory oversight.

7. **Financial Institutions should not be allowed to either become "too big or too interconnected to fail."** The problems that some of the very largest financial institutions have created and experienced raise the question as to whether some large financial institutions have become "too big to manage" and "too complex to regulate." If the

growth of these companies had been limited or had been better regulated, either to diminish their systemic impact or to curtail the risks they took, then these companies could have been allowed to fail or to reorganize without government bailouts. One single institution should not be allowed to control all levels of the financial services marketplace (from banking, to insurance, to investment, etc.) In the U.S, the law (Gramm Leach Bliley) that allowed banks to expand and merge into these giant multi-purpose financial institutions should be repealed, and replaced with a new Glass-Steagall type structure which addresses the risks of the new economy and effectively protects Main Street banks from these risks. Furthermore, it is important that competition and antitrust rules be reviewed and strengthened and their enforcement be robust to address the hazards posed by "too-big-to-fail" institutions. We also need to ensure that barriers to entry into these markets are minimized to allow smaller entrants to challenge large established financial institutions.

CONSUMER PROTECTION MUST BE A CENTRAL COMPONENT OF <u>REGULATING FINANCIAL SERVICES IN THE INTERNATIONAL ARENA</u>

Accounting Standards Harmonization: TACD would also like to take this opportunity to comment on two financial services projects that have long been on the U.S.-EU agenda. First, we note that regulatory convergence of accounting standards has long been a top Transatlantic Business Dialogue (TABD) priority. For years convergence meant gradual movement towards elimination of specific differences on a case-by-case basis. But in 2007, the U.S. Securities and Exchange Commission (SEC) agreed to a new rule allowing foreign companies in the U.S. market to file financial reports using International Financial Reporting Standards (IFRS) instead of being required to use U.S. Generally Accepted Accounting Principles (GAAP). This was less convergence than a complete capitulation to IFRS standards when the benefits of the changeover had not yet been demonstrated. To date, the EU has not reciprocated by allowing U.S. firms to file financial reports in the EU under GAAP. In August, the SEC proposed a roadmap that might let large companies abandon U.S. accounting standards by 2014. Under the plan, about 110 large companies may move to international rules as soon as 2010. While SEC chairwoman Mary Shapiro has expressed some concerns about the issue, the Bush administration roadmap has not yet been abandoned.

The recent financial services meltdown is a reminder, if one were needed, of the critical importance of ethical and accurate accounting practices not only for consumer and investor protection, but for global economic stability. In the past year, the weaknesses in both systems have been on full display. The standards of both with respect to off-balance sheet transactions have left investors in the dark and have fueled the recent crisis. But convergence to one set of standards is not necessarily the answer.

TACD has many concerns about the push for convergence, among them: In 1999, the U.S. Financial Accounting Standards Board concluded after an extensive comparative analysis of the differences between IFRS and GAAP that IFRS was of lower quality than GAAP.[1] Many academics have found that IFRS provided greater opportunities for

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[1] Financial Accounting Standards Board, *The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S. GAAP*, Second Edition, Oct. 1999, available at: http://72.3.243.42/intl/iascpg2d.shtml

earnings management ("cooking the books").[2] The International Accounting Standards Board (IASB), which sets and governs IFRS standards, has a meager budget and staff. It is funded by an industry that has a great deal of influence over the member seats and trustees. It is an extremely flawed venue for objective standard setting. Convergence is not necessarily a goal that benefits consumers; many academics argue that there are benefits of maintaining competing standards and that competition between standard-setters produces a type of check and balance on the race to lowest common denominator standards and results in efficiencies in many fields.[3]

TACD RECOMMENDATION

8. **Regulatory convergence in accounting standards needs to be reconsidered**. Over the many years of this debate, the SEC has not demonstrated how an increased reliance on IFRS will benefit U.S. investors and consumers. TACD was very pleased that the new head of the SEC has expressed caution with the Bush Administration approach to this matter. TACD recommends that recent events justify a halt to the Bush Administration's "roadmap," which would allow U.S. firms to file using IFRS as early as 2010. We also recommend that the SEC start from scratch with an open and transparent assessment of the strengths and weaknesses of both sets of standards, especially with regard to consumer and investor protection. If there is a pressing need for convergence of one particular standard, this can be done on a case-by-case basis with a pledge to raise standards, not lower them. But the SEC should not engage in a wholesale switch to IFRS standards with out clearly demonstrating how this dramatic and costly change would benefit consumers and investors. Instead, the SEC should return to a policy of gradual case-by-case convergence of individual standards that ultimately would create two compatible sets of accounting standards, that practically and effectively be used cross border.

Transatlantic Mutual Recognition Agreement (MRA) in securities: Second, we note that US-EU MRA on securities is an idea of the TABD that they may attempt to revive. The MRA is intended to allow broker/dealers in Europe to sell securities to investors in the United States and vice versa, without having to partner with a domestic firm, establish a commercial presence or be registered and licensed by the importing country's regulatory authorities. In other words, the signatory nations would exempt foreign broker/dealers from host country oversight and rely on home country regulators to police the brokers' activities abroad. The U.S. Securities and Exchange Commission (SEC) announced a similar MRA with Australia earlier this year, even after one SEC commissioner said such MRAs raised "serious investor protection concerns"[4] and would preempt the brokers self-regulatory and disciplinary efforts as well as and state security law oversight.

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[2] Teri Yohn, Associate Professor, Indiana University, Testimony U.S. Banking, Housing and Urban Affairs Committee, "International Accounting standards: Opportunities, Challenges and Global Convergence Issues."
[3] Shyam Sunder, Professor, Yale School of Management, Financial Times, September 18, 2008.
[4] SEC Commissioner Annette Nazareth, Remarks Before the Securities Industry and Financial Markets Association Annual Meeting, Nov. 9, 2007, available at: http://www.sec.gov/news/speech/2007/spch110907aln.htm

TACD has long been concerned about MRAs and issued a lengthy background paper on US-EU efforts towards MRAs in 2001.[5] MRAs can result in the transfer of regulatory authority from national regulatory agencies, which are to varying degrees transparent and accountable to their citizens, to foreign regulatory agencies, which are not as transparent or accountable to the citizens of the importing country. Loosening the bonds of oversight and accountability increases the potential for regulatory evasion by industry. In addition, the U.S. and the EU have extremely different policies and practices governing securities. These regulatory differences raise significant concerns for consumers. For instance, TACD would argue that the U.S. has much stricter listing practices for companies than many EU companies. A U.S.-EU MRA could result in U.S. investors purchasing risky securities from third party nations that would not be eligible for listing in the United States.

TACD RECOMMENDATION

9. **U.S.-EU MRA on securities should be abandoned:** The premise of the above MRA's is that the countries involved will recognize each other's regulatory policies as similar enough to provide equivalent levels of protection for investors. TACD believes that both sides of the Atlantic are plagued with extremely weak regulatory regimes in financial services, the very industry that has been the root cause of the recent global collapse and recession. Deeply flawed regulatory structures should not be internationalized. If this policy is to be pursued at all, which we do not advise, it should only be considered after weak regulations have been substantially improved upon domestically and only if it can be shown that such a policy offers at least comparable levels of consumer and investor protection. We applaud the recent U.S. move to put this MRA on hold and recommend that no further liberalization in this regard be pursued.

Current and Future Trade Rules Governing Financial Services: The UN Commission of Experts on the Financial Crisis, chaired by Nobel-laureate Joseph Stiglitz, recently concluded that: "Many bilateral and multilateral trade agreements contain commitments that circumscribe the ability of countries to respond to the current crisis with appropriate regulatory, structural, and macro-economic reforms and rescue packages, and may have exposed them unnecessarily to the contagion from the failures elsewhere in the global economic system." For instance, the World Trade Organization's Financial Services Agreement and related texts include a "standstill" commitment - meaning that signatory countries, including the US and EU, are forbidden from regulating financial service sectors bound to the agreement in any way that violates the deregulatory constraints of the agreement. Furthermore, the US and EU are bound to ensure that foreign financial service suppliers are permitted "to offer in its territory any new financial service," a direct conflict with TACD's call for the development of regulatory structures that allow for the prior approval of risky investment instruments. The agreement also requires the US and the EU not to pursue any action that alters the "conditions of competition" in favor of their domestic banks and financial services firms. As part of this requirement, bank bailout money must be provided on a national treatment (nondiscriminatory) basis to foreign and domestic banks. New financial services regulations can be challenged in WTO trade tribunals, which put the interest of trade above all other concerns, and the carve out for prudential measures contained in the

[5] This background paper is available here:
http://tacd.org/index2.php?option=com_docman&task=doc_view&gid=102&Itemid=40

agreement may not be sufficient to safeguard the diversity of regulatory reform measures being proposed. These trade-related deregulatory constraints must be reviewed and repaired if policymakers and regulators are to be free to address the crisis in the manner they see fit, without threats of trade disputes and retaliation hanging over the heads. Developing countries especially need policy framework and policy space to protect themselves from regulatory and macro-economic failures in systemically significant countries.

TACD RECOMMENDATION

10. Trade Rules Governing Financial Services Need to be Reviewed and Repaired: The push for increased financial services liberalization as part of the Doha Round should be abandoned. Most governments of the world lack the robust regulatory structure needed to govern large multinational financial service firms and should not be required to abide by trade-related deregulatory constraints, market access requirements for financial services firm or their risky products, or national treatment requirements to provide aid to foreign firms on the same basis as domestic firms. New WTO disciplines on accounting that will be operationalized at the conclusion of the Doha Round, should be abandoned. Nations of the world should not have to justify the "necessity" or "least trade restrictiveness" of any accounting reforms they may undertake in response to the crisis. The US and the EU should publicly commit to refrain from any WTO suits related to the financial crisis or any other type of trade suit and should urge their companies to refrain from investment suits against developed and developing nations related to the crisis.

Commodities Futures Markets: Commodities futures markets are systematically important financial institutions whose price risk management contracts had a notional value of $13 trillion in 2007, according to the Bank for International Settlements. Futures contract prices are benchmarks for cash prices of agricultural, energy, base metal and precious metal commodities that strongly affect the affordability and availability of consumer products and food. According to a report prepared for the G-20 Heads of State meeting on April 2, the U.S. Commodities Futures Trading Commission, the United Kingdom's Financial Services Authority, and the International Monetary Fund agree that financial speculation in commodities exchanges did not "systematically cause" price increases and volatility.[6] TACD strongly disagrees, since these assessments did not evaluate the affect of commodity index fund trades, bundling 30-40 (depending on the fund formula) percent of all futures contracts, on price increases and volatility. Nor did these assessments evaluate the price impacts of deregulation and de-supervision of commodity exchanges and their investors. Before another food or energy crisis breaks out aided by commodities futures speculation, TACD recommends the following.

TACD RECOMMENDATION

11. The U.S. and EU should cooperate to develop a floor for new futures market legislation. This legislation should: require that all commodities derivatives trades be executed on publicly regulated exchanges and that all trading data be reported promptly and completely to authorities; require commodity-specific speculative position limits (i.e., total value of futures contracts) to be set and applied, without exemptions or waivers,

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[6] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD285.pdf

equally to all exchange participants, to prevent “weight of money” from inducing price volatility; Require that groups advising regulators on position limits and other regulations include representatives of those affected by regulatory decisions, such as consumers, in addition to representatives of market participants.