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CORPORATE GOVERNANCE

Regulating the financial landscape

■ Global regulation a reality at last

Following our February report examining the failure of corporate governance in the European banking sector, this note examines the global sector's changing regulatory structure in the wake of the G20's decision in April to establish the Financial Stability Board (FSB) as the world's first overarching financial regulator.

■ The FSB: does it have teeth?

The FSB's mandate is to restore trust by strengthening financial regulation. In this respect, its authority to regulate hedge funds and uncooperative tax havens signals a much needed shift from a principles-based approach (soft law) to regulation (hard law). However, the FSB's lack of regulatory and punitive powers dramatically weakens its ability to regulate.

■ Basel II may be the saviour of pay reform

The G20 has mandated the FSB to implement the compensation principles for 'systemically significant' financial organisations set out by its predecessor, the Financial Stability Forum (FSF). However, we believe these principles are insufficiently detailed to discourage the short-term focus of incentive schemes that generate unnecessary risks. In fact, we think Basel II may prove to be the saviour when it comes to pay restraint, as the increased capital requirements it will introduce will result in lower profits, which should act (in the short term) as a brake on payouts.

■ Europe: no coordination on corporate governance

Europe hosts some of the world's biggest capital markets whose activities have become increasingly cross-border, while still being regulated at national level. From a governance perspective, we are surprised that the European Commission's communiqué on financial supervision makes no recommendations on corporate governance, particularly in the area of remuneration reform.

■ Safe to surf the financial waters again?

We believe an ivy league of big banks will emerge in Europe, comprising **Credit Suisse**, **Deutsche Bank**, **BNP Paribas** and **Santander**. For these banks, we expect a continuing flight to quality correlating with the perception of superior financial strength going forward. In our view, 'over-regulation' of big banks will sharply increase the importance of the size factor (barriers to entry), and only leaders will have the capacity to invest fast enough to comply with new regulations designed to reduce risk.

Executive summary

FSB offers opportunity for more coordinated regulatory approach

The establishment of the Financial Stability Board (FSB) appears to be the first step in a more coordinated approach towards regulation and supervisory standards at global level. We believe that the global financial environment has been transformed and that there is now greater political will to regulate. The ability of individual states to successfully reform their regulatory and supervisory standards will require parallel action and co-operation by other national financial systems, and it is here that we believe the FSB can play a crucial role.

Remuneration reform continues... but global standard may not be panacea

The FSB's mandate includes the implementation of guidelines on compensation practices designed to reduce the excessive risk-taking viewed as one of the contributing factors of the current financial crisis. However, although the proposed guidelines offer a first step towards a global framework, they provide no specific detail on how national governments can ensure that the remuneration programmes of financial institutions avoid excessive risk-taking and instead reflect sustainable long-term performance. In addition, the absence of any reference to corporate governance and specifically remuneration reform in the European Commission's communiqué on financial supervision indicates that there is perhaps not yet a coordinated approach to remuneration reform at European level. Instead, we believe the increased capital requirements of Basel II will be the most likely contributor to pay reform in the next few years.

Role of sovereign wealth funds in stabilising global financial system

Sovereign wealth funds (SWFs) have become significant players in recent few years and have been viewed as a stabilising force on global financial markets – particularly given their capital injections into systemically important financial institutions in late 2007 and 2008, which augmented capital buffers and helped reduce risk premiums for some banks in the short term. However, as the prominence of SWFs has increased, so have concerns over their primary role as the investment arm of governments. In our view, their lack of transparency and passivity in terms of corporate governance may not be good for the long-term corporate health of financial institutions.

Urgent need for coordinated European regulatory approach

The financial crisis has highlighted the lack of regulatory solidarity in Europe, even though the region hosts some of the world's biggest capital markets whose activities have become increasingly cross-border, while still being regulated at national level. The European Commission's communiqué on financial supervision proposed the creation of: 1) three supranational entities with mandatory mediation powers and regulatory responsibility for Banks, Insurance and Securities; 2) a European Systemic Risk Council with a mandate for macro-prudential supervision; and 3) a college of financial regulators. We believe these new bodies would represent key steps towards the creation of a more unified European regulatory and supervisory system.

Investment banking to be hardest hit by restructuring

The transformation of the banking industry will probably be most pronounced for investment banks, although regulatory changes will also impact retail banks and the asset management industry. While investment banks are already deleveraging and redefining their business models, there is a clear push towards higher capital requirements in the medium term, with competition authorities calling for rescaling of businesses, changes to corporate governance and incentives and the redesign of risk management frameworks. All of this will have an impact on capital deployment strategies and the cost of capital. We expect the emergence of an ivy league of big banks in Europe, comprising **Credit Suisse**, **Deutsche Bank**, **BNP Paribas** and **Santander**. For these banks, we expect a continuing flight to quality that correlates with the perception of higher financial strength going forward.

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In recent months, the FSF has become the arena where national governments' crisis measures can be co-ordinated

I – FSF metamorphoses into FSB

The G20 London Summit on 2 April announced that, as part of its commitment to strengthen the financial system, the Financial Stability Forum (FSF) would be placed on stronger institutional ground and reformed into the Financial Stability Board (FSB) in order to ensure its effectiveness as a mechanism for national authorities and international financial organisations to address vulnerabilities and develop and implement strong regulatory, supervisory and other policies that favour financial stability.

This is not surprising, given that the FSF was set up as a forum for central bankers and supervisors to meet and discuss macro-economic issues. Furthermore, the FSF has in recent months become an arena where central banks can co-ordinate the crisis measures taken by each government.

What was the purpose of the Financial Stability Forum?

On 3 October 1998, Dr Hans Tietmeyer, President of the Deutsche Bundesbank, was commissioned by the Finance Ministers and Central Bank Governors of the G7 countries to recommend new structures for enhancing co-operation between the various national and international financial institutions. Dr Tietmeyer presented his report to the G7 Ministers and Governors on 20 February 1999 and proposed the creation of a Financial Stability Forum (FSF), which in light of the Asian Financial Crisis in 1997, would help to promote international stability through information exchange and international co-operation in financial supervision and surveillance.

The Financial Stability Forum (FSF) brought together senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. Mr Mario Draghi, Governor of the Banca d'Italia, currently chairs the FSF in a personal capacity.

The 1997 Asian financial crisis indicated the need for closer international co-operation in financial supervision and surveillance and the present mandate of the FSF is not far away from the proposed new responsibilities of the FSB. Despite this, the FSF did not begin to look at the regulatory structure of banks until after the emergence of the credit crisis in the summer of 2007.

CURRENT MANDATE OF THE FINANCIAL STABILITY FORUM

Assess vulnerabilities affecting the international financial system

Identify incipient vulnerabilities in national and international financial systems, foster concerted procedures for a better understanding of the sources of systemic risk and formulate effective financial, regulatory and supervisory policies to mitigate them.

Identify and oversee action needed to address these

Ensure that international rules and standards of best practice are developed and implemented, and that gaps in such standards are effectively identified and filled.

Improve co-ordination and information exchange among the various authorities responsible for financial stability

Improve arrangements to ensure that consistent international rules and arrangements apply across all types of significant financial institutions, and that procedures exist for the continuous flow of information among authorities having responsibility for financial stability.

Source: CA Cheuvreux

**The FSB appears to
be the first step
towards a global
regulator...**

**... but the devil is in
the detail**

Why was so little attention paid to the FSF?

The FSF, which has operated for most of the past decade, was a forum for central bankers and supervisors to meet and exchange views. However, their discussions were very discreet and barely noticed by the wider world. Furthermore, membership of the FSF was based on the Finance Ministers of the G7¹, which in our view may have reduced the ability of the FSF to co-ordinate information exchange globally in order to identify areas of systemic risk early enough.

Lack of international consensus to act on introducing stronger regulation pre-crisis also appears to be a factor. The national leaders of Germany and France have over the last few years been pushing for tougher regulation of banks and more transparency in the financial sector. However, without the support of the other members, particularly the US, it was inevitable that bodies such as the FSF would be unable to implement the tougher regulation needed to tackle systemic risks.

Finally, the FSF, despite its mandate, was essentially an advisory forum for G7 Finance Ministers and had no regulatory bite or enforcement powers.

■ Does FSB's emergence signal retreat of the state?

The FSB will be expanded to include all G20 countries, previous FSF members, Spain and the European Commission. The FSB will also incorporate an enhanced operating structure consisting of two main committees: the Plenary and the Steering Committee. However, other committees and subgroups will be established as needed including a secretariat based in Basel, Switzerland.

The Plenary, as under the FSF, will continue to act as the decision-making organ of the FSB with its members comprising the heads of the member states' treasuries, central banks and supervisory agencies, the chairpersons of the main standard-setting bodies and central bank committees and senior representatives of international financial institutions. The Steering Committee will provide operational guidance between plenary meetings to implement the directives of the FSB and ensure effective information flow to members.

KEY AREAS OF RESPONSIBILITY FOR THE FINANCIAL STABILITY BOARD

SUPERVISION

- Collaborate with the IMF to provide early warning of macro-economic and financial risks and the agree actions needed to address them.
- Establish and support supervisory colleges.
- Manage contingency planning for cross-border crisis management particularly in respect of systemically important financial firms.

REGULATION

- Reshape regulatory system so that international authorities are able to identify and take account of macro-prudential risks.
- Extend regulation and oversight to all systemically important financial institutions, instruments and markets, including systemically important hedge funds.
- Achieve a set of high-quality global accounting standards.
- Extend regulatory oversight and registration to credit rating agencies.

ENFORCEMENT

- Implement the principles on pay and compensation endorsed by predecessor, the FSF, so as to ensure consistency across jurisdictions.
- Take action against non-cooperative jurisdictions, including tax havens.

Source: CA Cheuvreux

¹ The G7 comprised Canada, United States, United Kingdom, France, Italy, Germany and Japan.

The FSB's lack of powers to sanction and enforce undermines its ability to regulate...

... but it may be able to 'name and shame'...

... and co-ordinate regulation at national level

The establishment of the FSB flowed from the third pledge (strengthening financial regulation and restoring trust) of the communiqué released by the G20 at the end of the London Summit on 2 April 2009. The communiqué presented the establishment of the FSB as a necessary solution to the problems caused by the financial crisis that have become too large and interdependent for states to confront and address individually.

However, we believe this pledge to strengthen financial regulation and rebuild trust could prove to be both controversial and difficult given that the mandate of the FSB in effect requires members to cede regulatory power to a supranational institution.

The re-regulation of macroeconomic and financial risk at national level is already underway as countries seek to assess what went wrong and how best to ensure a stable financial system. The FSB with its expanded membership may find that reaching a timely consensus and a coordinated course of action among its members will not be easy.

Furthermore, the role and responsibilities of the FSB are significant and broad, and include hedge fund regulation, tax haven supervision and monitoring alongside the IMF and implementation of compensation principles for financial institutions. However, it is unclear how the FSB will perform its role as a quasi international regulator to impose global consistency and to monitor macro-economic risk given that like its predecessor, the FSF, it will act as an advisory body, with no formal powers to impose decisions on its members.

Will peer pressure be enough to drive enforcement?

As we have identified, a key weakness of the FSB may be its lack of a specific enforcement mechanism that could be used to ensure that members follow through on commitments and the FSB's recommendations. However, members of the FSB will commit to undergo periodic peer reviews which the FSB will be able to report on and publish. This process should act as a motivator, by naming and shaming states that have not implemented agreed commitments.

Furthermore, success by individual states in terms of reforming their regulatory and supervisory standards will require parallel action and co-operation by other national financial systems and it is here that we believe that an organisation like the FSB could play a crucial role. We believe that the global financial environment has been transformed, and that there is now much greater political will to regulate. In our view, this new reality may be instrumental to the success of the FSB.

Concentrating on systemically important hedge funds alone could create a two-tier system, with the second tier continuing to operate in obscurity

II— Regulatory race to the top

There is general agreement among G20 members that financial oversight, transparency and conduct are required to overhaul the global economy. The financial crisis has provided the impetus for national governments to tackle previously unregulated hedge funds and uncooperative tax havens.

Via the FSB, there is now the potential for a global approach to the regulation of 'systemically important' institutions, markets and instruments hedge funds, uncooperative tax havens and the compensation practices of financial institutions.

Hedge funds and tax havens caught offside in new regulation game

The move to increase transparency and regulation must also include the removal of regulatory black holes which have hitherto sheltered hedge funds and tax havens. In our view, the FSB clearly has some work to do, primarily in providing a clear definition of 'systemic importance'. Furthermore, there appears to be some overlap between the need to regulate 'systemically important' hedge funds and more general calls from the G20 for hedge fund regulation via registration (of either the fund itself or of its manager). We believe that the FSB may find it difficult to determine which hedge funds are 'systemically important', particularly as this only becomes clear when such hedge funds fail.

In addition to the uncertainty over how the FSB will define 'systemic importance', we believe regulation of systemic hedge funds will create two risks:

- first, an unintended consequence of concentrating on the systemically important hedge funds could be the creation of a two-tier system with a second tier comprising less regulated (registered) hedge funds that continue to operate in relative obscurity compared with their more tightly regulated (systemic) peers;
- second, the monitoring and oversight of hedge fund operations will be extremely difficult and regulators like the FSB must be open about the limits of their oversight to ensure that any such regulation does not create a false sense of security.

Level playing field means nowhere to hide

The G20 declaration that the "era of bank secrecy is over" has highlighted the increasing pressure on (cash-starved) governments to tackle this problem collectively. The publication by the OECD of a list of countries assessed against the international standard for exchange of tax information² represented a significant first step towards creating a level playing field. The OECD's list publically highlighted countries that have not yet committed to implementing agreed international tax standards and it this ongoing pressure that has led to a number of countries choosing to act ahead of the G20 London summit, either by committing to or by substantially implementing international agreed tax standards. These include Austria, Belgium, Luxembourg, Monaco, Andorra, Asian financial centres (Hong Kong, Singapore) and various British Crown dependencies and offshore territories (Channel Islands, Cayman Islands, etc).

² The OECD published this list immediately after the release of the G20 communiqué on 2 April 2009.

KEY REGULATORY INITIATIVES OVER LAST 18 MONTHS

Organisation/Country	Proposals
Group of 30	Chaired by Paul Volker, the Group of 30 issued 18 reform proposals that are "inter-related changes in policies, practices and market standards". According to Group of 30 analysis, the proposals should be seen in the context of four broadly stated core recommendations: 1. Gaps and weaknesses in coverage of prudential regulation and supervision must be eliminated. All systemically significant financial institutions, regardless of type, must be subject to an appropriate degree of prudential oversight. 2. The quality and effectiveness of prudential regulation and supervision must be improved. This will require better resourced prudential regulators and central banks operating within structures that afford much higher levels of national and international policy coordination. 3. Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital and liquidity. Regulatory policies and accounting standards must also guard against pro-cyclical effects and be consistent with maintaining prudent business practices. 4. Financial markets and products must be made more transparent, with better aligned risk and prudential incentives. The infrastructure supporting such markets must be made much more robust and resilient.
UK	The UK Turner Review's proposals for regulatory changes are split between national action and international reform. Within the different proposals the report highlighted: ▪ The need for increase and enhancement of capital; this also covers a significant increase of capital allocated to the trading book (several times higher); ▪ The adaptation of Basel 2 framework in order to smooth cyclicity; requirement for higher level of capital and buffers should be spread over time; liquidity regulation should also be improved and a cap should be put on gross leverage (limit excessive growth of balance sheet); ▪ Incentives to be aligned to performance and remuneration policies to be designed to avoid undue risk taking.
EU	The high-level de Larosière Group report on supervision in the EU highlighted the need to correct regulatory weaknesses, to have a new set of rules and to improve corporate governance, but the key point of the report was in the proposal on cooperation between supervisors. The report calls for more capital and for a solution to the shortcomings of Basel 2 (liquidity consideration, dependence on external ratings in risk assessment). The most critical part of the report was on cross-border issues, highlighting the need for a common definition of capital in Europe. The report says that "a process should be launched to remove key differences stemming from the derogations, exceptions and vague provisions currently contained in some directives". However, on common supervision the report takes the view that the ECB should not become responsible for the micro-supervision of financial institutions. The report also supports the creation of a new group, replacing the current Banking Supervision Committee (BSC) of the ECB, called the European Systemic Risk Council (ESRC), to be set up under the auspices and with the logistical support of the ECB. Its task will be to form judgements and make recommendations on macro-prudential policy, issue risk warnings, compare observations on macro-economic and prudential developments and give direction on these issues. This proposal was recently adopted by the EU (Ecofin meeting) and will be enforced before year-end. This scheme will lead to far stronger supervisory and sanctioning regimes in the EU.
US	The recently published US Treasury report, Rebuilding financial supervision and regulation, also focused on the need for a superior and consistent supervision framework (no firm left out of the scope). This is also a target for financial market supervision and the report asked for fair treatment of securitisation, notably in improving market transparency and introducing, as in the EU, a 'retainer' for originators and brokers in securitised loans. Better protection of consumers and investors is also a key target of the report, calling for the creation of a new body dedicated to that task. Apart from internal efforts, the US report also acknowledges that international cooperation is required: "internal reforms to support our efforts at home, including strengthening of capital framework; improving oversight of global financial markets; coordinating supervision of internationally active firms; and enhancing crisis management tools".
G20 London Summit	The G20 communiqué published on 3 April agreed principles to reform the global banking system. Significant reforms included the introduction of a new systemic regulator, the 'Financial Stability Board', to replace the Financial Stability Forum. The FSB's mandate is broad, including new regulation and oversight for hedge funds, setting of international accounting rules and increased regulation and transparency for credit rating agencies. In addition, sanctions were announced for tax havens that do not co-operate with international tax disclosure requests. To facilitate this, the OECD published (simultaneously with the communiqué) a list of tax jurisdictions that do not currently comply with international standards for tax information exchange. Finally, the G20 announced that it would implement the Financial Stability Forum's principles on pay and compensation for financial institutions.

Source: CA Cheuvreux

■ Role of sovereign wealth funds in restoring financial stability

WEALTH FUNDS TO THE RESCUE OF SYSTEMICALLY SIGNIFICANT FINANCIAL INSTITUTIONS

Company	Investor	% Stake	Investment Value in US\$ Millions	Security Type
Citigroup	Abu Dhabi Investment Authority	4.9	\$7,500	New Convertible Units
Citigroup	Government of Singapore Investment Corp.	3.7	6,880	New Convertible Units
Citigroup	Kuwait Investment Authority	1.6	3,000	New Convertible Units
Merrill Lynch	Kuwait Investment Authority	3.0	2,000	New Convertible Units
Merrill Lynch	Korean Investment Corp.	3.0	2,000	New Convertible Units
Merrill Lynch	Temasek Holdings	9.4	4,400	New Common Stock
Morgan Stanley	China Investment Corp.	9.9	5,000	New Convertible Units
Barclays PLC	Temasek Holdings	1.8	2,005	Common Stock
Credit Suisse	Qatar Investment Authority	1.0	603	Common Stock
UBS	Government of Singapore Investment Corp.	9.8	9,750	New Convertible Units
UBS	Saudi Arabian Monetary Agency	2.0	1,800	New Convertible Units
Total Cash Infusions from Sovereign Wealth Funds			\$44,938	

* Funds purchased convertible units that can be converted into equity at a future date.
Source: Sovereign Wealth Fund Institute, Official Press Releases, updated 1 April 2008

The present financial crisis has ensured that financial stability is now at the centre of policy discussions while at the same time sovereign wealth funds (SWFs) have become much more significant to the global economy.

Although precise definitions for sovereign wealth funds may vary, they can essentially be divided into two groups: 1) funds based on raw material revenues; and 2) funds built on asset transfers from expanding foreign reserves. However, growing direct and significant investment by SWFs in banks and other financial institutions in the West has led to increasing tensions over their transparency and governance.

According to the US Treasury, SWFs are already large enough to be systemically significant and despite being criticised for low corporate governance standards and transparency and a potential threat to national interests, SWFs are now being welcomed as a potential source of investment for struggling financial institutions wanting to retain their independence and freedom from government interference. It is clear that national governments cannot bail out the financial system on their own and the power of SWFs as a stabilising force could prove very important to the recovery of the global economy.

For example, capital injections by SWFs into systemically important financial institutions in 2007 and 2008 certainly augmented their capital buffers and helped reduce the risk premium for some banks (in the short term). SWFs have significant implications for multilateral surveillance and financial stability analysis and have thus the potential to affect the International Monetary Fund's mandate to ensure the effective functioning of the international monetary system.

National governments cannot bail out the financial system on their own

From a governance perspective, passive SWFs may not be good for the long-term corporate health of financial institutions

There is now a greater need for a more systemic approach to SWFs, given their active role in the international monetary and financial system

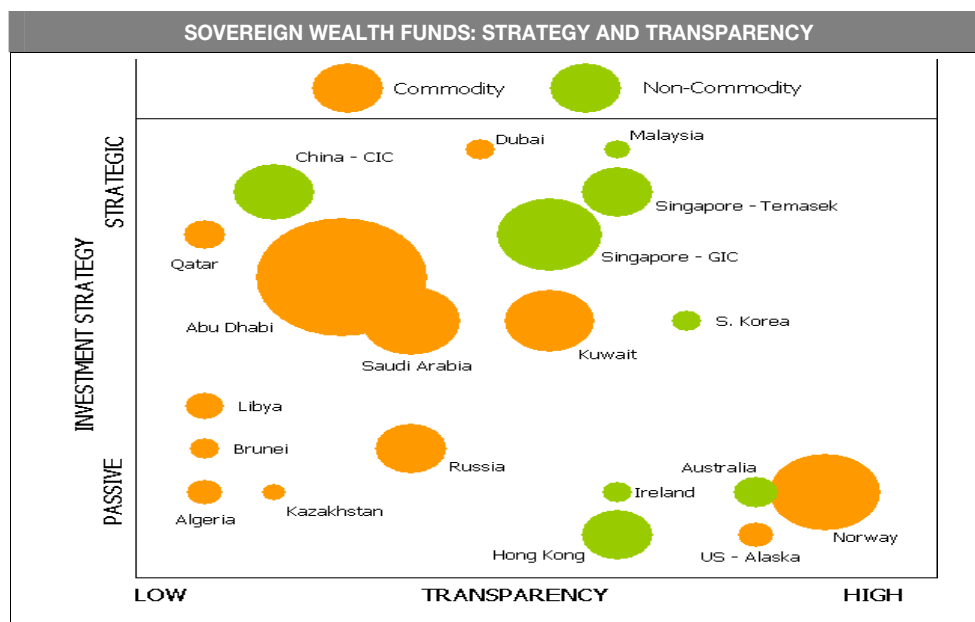
Transparency improving, but lack of activism diminishes governance

The agreement in October 2008 by representatives of the largest 25 SWFs to commit to a set of generally agreed principles and practices called 'The Santiago Principles'³ clearly highlights the movement by SWFs towards increased transparency and disclosure. These voluntary guidelines, which were agreed alongside IMF representatives, incorporate a code on transparency of investment criteria and address three broad areas of concern for SWFs: 1) their legal structure, relationship with the state, policy and investment objectives and degree of coordination with their sovereign's macroeconomic policies; 2) their institutional structure and governance mechanisms; and 3) their investment and risk management framework. In addition, the OECD recently reported to the IMF on how SWFs and recipient countries should work together, including guidance on how countries might deal with politically motivated investments.

However, these principles are voluntary and have been criticised for being light on transparency, particularly the lack of a requirement to disclose fund size. Furthermore, a clear consensus has not been reached on the amount of influence SWFs should have over their investments. In our view, the passivity of some SWFs may reduce the effectiveness of corporate governance for their investments. We note that most current SWF investments in financial institutions do not include any form of board representation. For example, the Government of Singapore Investment Corporation refused a board seat offered by UBS as its largest shareholder in 2008.

SWFs have the ability to help distressed financial institutions seeking to avoid state aid in order to remain independent and government interference by injecting capital. However, we believe such moves may not be good for the institutions' long-term corporate health.

Although IMF fund surveillance already covers SWFs, the push towards systemic regulation appears to have ignored the increasing importance of SWFs. In our view, it is now even more important to establish a more systemic approach to SWFs, given their role as active participants in the international monetary and financial system.



Source: Sovereign Wealth Fund Institute

³ International Working Group of Sovereign Wealth Funds, Sovereign Wealth Funds: Generally Accepted Principles and Practices "Santiago Principles" October 2008.

■ Europe cannot afford to let this crisis go to waste

The propagation of problems to most European countries has required unprecedented levels of state support on bank liquidity in order to prevent 'systemic' banks going bankrupt. However, these pure capital injections were limited in comparison to the size of the losses and exposures and most of the state support was given in the form of subordinated debt injections.

European governments are now in a position to be significant shareholders of banks:

- UK (100% of Northern Rock, 70% of RBS and 45% of Lloyds Banking Group)
- Ireland (100% of Anglo Irish)
- Benelux (100% of ABN-Amro, 65% of Dexia, 20% of KBC)
- Germany, directly (towards 100% of HRE) and indirectly via state-owned banks (KfW's position in failed IKB).

For the rest of the banking industry the state support via Tier 1 debt creates an immediate dilution due to the cost of the hybrids and a potential additional dilution since the hybrids should be exchanged for ordinary shares in the coming years (at least retained earnings will have to repay for Tier I debt). However, the European schemes are not supposed to be quickly repaid as in the case of the US TARP support plan.

However, some banks have stayed out of the capital injection schemes, including HSBC, Standard Chartered, Barclays, Deutsche Bank, CS Group, and all the Spanish banks including BBVA and Santander. Within this group of large banks, only Deutsche Bank and BBVA have not issued new capital as a result of the current crisis.

Following the crisis, the refounding of banking businesses and financial infrastructure is a key issue for all states and supervisors. As expected, the main changes will occur within Commercial and Investment Banking (CIB) but Asset Management (AM) is not isolated from changes. Following the G20 meeting of April 2009, the UK, EU and US have published a roadmap for the reform of the finance industry. This crisis was born in the US and the new US administration is setting up a new framework to replace an outdated one.

The inclusion of the European Commission as a member of the decision-making organ of the FSB (plenary) is certainly a necessary step towards increased co-operation and co-ordination at international level.

However, Europe hosts some of the world's biggest capital markets whose activities have become increasingly cross-border, while still being regulated at national level. Therefore any increased cooperation with international entities such as the IMF, FSB and the Basel Committee to coordinate global best practice standards will fail unless there is an integrated European system for regulation and supervision.

TABLE 4: STATE GUARANTEE SCHEMES

Country	Nationalisation	Capital injection		Debt	Guarantee	Guar/funding
		Amount	EUR	Tier 1	on assets	EUR
Europe		316bn				2260bn
UK	Northern Rock B&B Dunfermline	60bn	RBoS Lloyds Banking	RBoS Lloyds Banking	RBoS Lloyds Banking Barclays	540bn (a)
Sweden	Carnegie Kaupthing Sweden	5bn		Swedbank		13bn
Spain	Caja CM	3bn (c)			Caja CM	100bn
Portugal	BPP BPN	4bn				20bn
Norway						40bn
Netherlands	ABN Amro Fortis NL	37bn	ING SNS Reaal Aegon	ING	ING	200bn
Italy		20bn		Unicredit Intesa SP MPS UBI BPMilano		yes
Ireland	Anglo Irish	10bn	AIB BKI	AIB BKI	yes	485bn (a)
Greece		5bn		NBG, EFG Euro Alpha, Piraeus, ATE HellenicPostBank		15bn
Germany	HRE	80bn	Commerz LandesBank	Commerz	HRE LandesBank	400bn
France		40bn	Dexia	BP/CE BNPP SocGen Crédit Agricole Crédit Mutuel	Dexia	320bn
Finland	Kaupthing Finland	4bn				50bn
Denmark	Roskilde Fiona	13bn				
Belgium		20bn	Fortis Holding Dexia KBC Ethias	KBC	Fortis Holding Dexia KBC	yes
Austria	Constancia Privat Kommunalkredit	15bn		Erste Bank Bank Austria BAWAG		75bn (a)

Note: (a) also covers additional guarantees on deposits, (b) available amounts, (c) commitment to invest up to €60bn in 2009-10, if required

Source: CA Cheuvreux

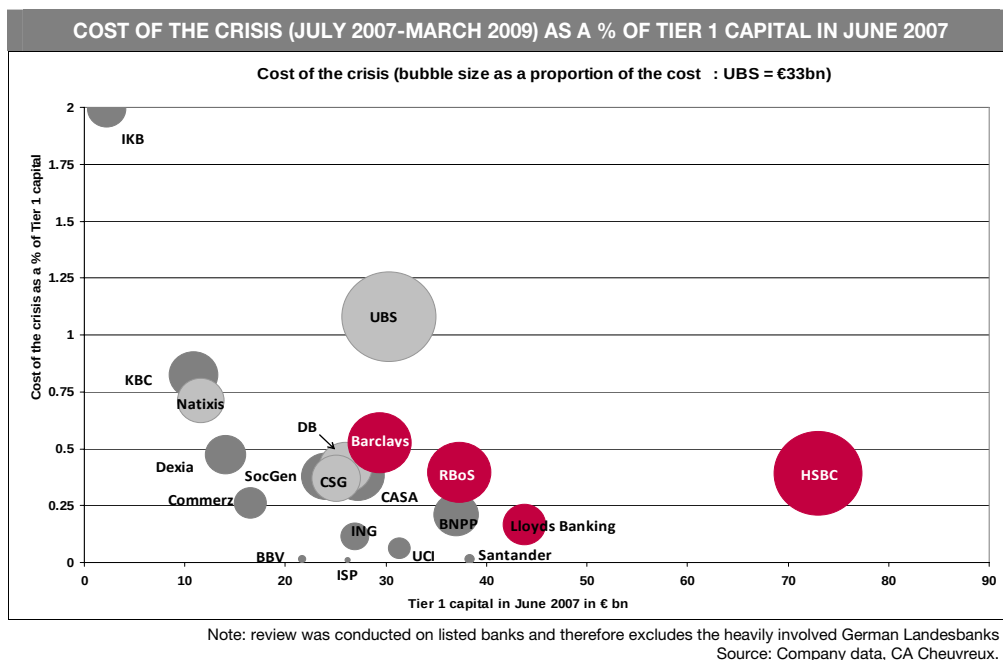
The failure of national European regulators to exchange information and adopt clear rules has been viewed as a contributory factor in the downfall of Fortis

The European Commission last October established an ad-hoc high-level group on financial supervision led by Jacques de Larosière to provide suggestions for the future of financial regulation and supervision. The de Larosière report published before the London G20 summit on 14 March suggested that while supervision of cross-border financial groups should remain a national affair the principle problem remains that there is no mechanism to enforce decisions on national regulators where they fail to agree on an issue, and as a result national regulators may have been unaware of the impending collapse of financial groups until a few hours before they occurred. We note that Didier Reynders⁴, Belgium's Finance Minister, has publically stated this is what happened in the case of Fortis Group.

⁴ Didier Reynders, Belgium Finance Minister speaking at the European Business Summit, 26 March 2009.

The de Larosi re report suggested the need for three new EU authorities for banks, securities and insurance firms that would have the power to enforce 'legally binding mediation between national supervisors.'

The report also called for the creation of a new body, the European Systemic Risk Council (ESRC) which would be chaired by the European Commission and in a similar role to the FSB and IMC provide macro supervision by retaining oversight of systemic risks affecting the global financial system.



Finally, we note that corporate governance is also viewed by the report as one of the most important failures of the crisis. In our view, there are two key recommendations: first, bonus awards should be assessed and paid over a multiyear framework with poor performance resulting in deductions over a five-year period; second, national supervisors at global level should monitor remuneration policies at financial institutions and, where they are deemed to be inappropriate or encouraging unnecessary risk, use pillar 2 of the Basel framework to force such institutions to set aside additional capital.

Levelling out the European regulatory vista

The European Commission in its communiqué on financial supervision in Europe on 27 May 2009⁵ announced two key recommendations that mirror the proposals made by the de Larosi re group:

- the creation of a European Systemic Risk Council (ESRC) responsible for macro-prudential supervision;
- the establishment of a European System of Financial Supervisors (EFSF) consisting of a network of national supervisors working in tandem with three new supervisory authorities responsible for the banking, securities and insurance and occupational pension sectors.

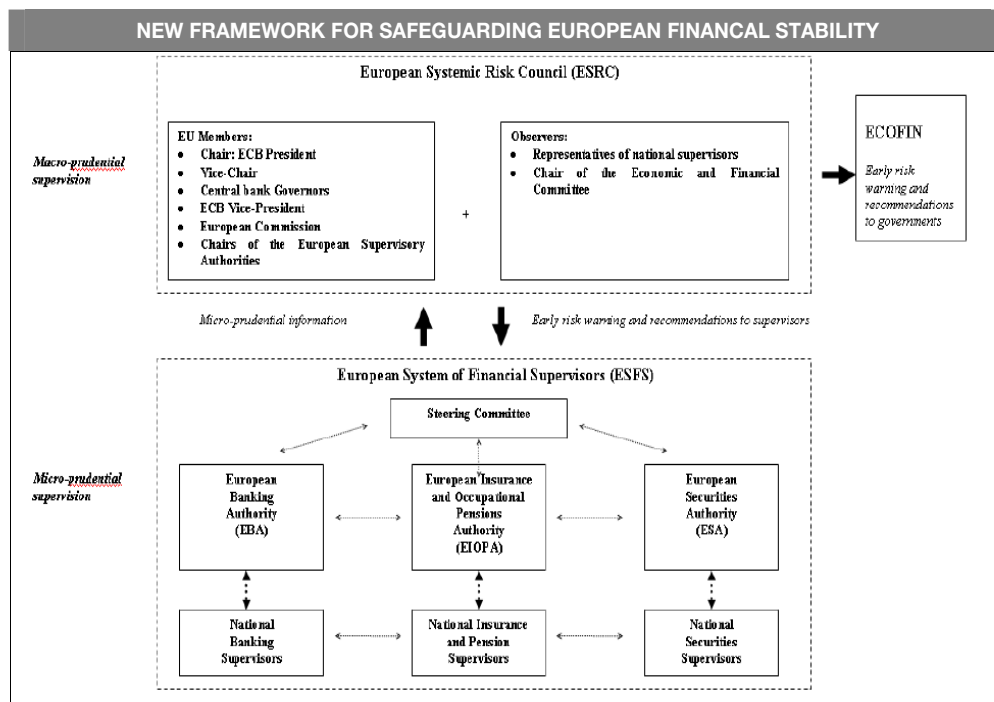
The EC's proposals, particularly the ESFS which will establish supranational regulators with binding mediation powers over national regulators, at first glance appear to have put Europe ahead in the regulator race despite the fact that the ESRC appears to be similar to the FSB given its macro-prudential supervisory role and lack of legally binding regulatory powers.

The EC's proposals lay the foundation for a single European regulatory and supervision system...

... but it remains unclear who will pay when a cross-border financial institution fails!

⁵ These proposals were affirmed on 17 June by European leaders at a Brussels summit.

However, the EC's proposal to give binding powers to three new pan-European supervisory bodies is likely to be resisted by national governments who may not be in favour of handing over their authority to a centralised regulator. Nor is it clear how responsibility will be split between national regulators and the three supranational regulatory authorities.



Source: European Commission communication of 27 May 2009, 'European Supervision'

The EC's communiqué on financial supervision makes no reference to the need for a common European approach to corporate governance reform or the use of increased capital requirements under Basel II to reign in inappropriate remuneration practices

What is more, while the EC's proposals outline a framework for establishing a single European regulatory and supervisory system they do not clarify who would be responsible for regulating cross-border financial institutions and as a last resort bailing out such financial groups when they have failed. For example, the Santander Group is headquartered in Spain but has branches in 12 other states and is supervised by the regulatory authorities of each of the states in which it operates. The argument could be made that the Spanish state should perhaps have more general control over the supervision of Santander⁶; however, national objections and legal issues make this difficult in practice, resulting in poor supervision and higher risk.

What is most surprising is that whilst the de Larosiere report considered the failures in corporate governance to be an important contributor to the financial crisis, the EC's communiqué on financial supervision makes no reference to the need for a common European approach to corporate governance reform or the use of Basel II capital requirement as a tool to reign in inappropriate remuneration practices. We believe that the EC may have missed a unique opportunity to apply a unified approach to corporate governance in Europe.

⁶Speech by Lorenzo Bini Smaghi, Member of the Executive Board of the ECB 2009 ECON meeting with national parliaments
Financial crisis: Where does Europe stand? Brussels, 12 February 2009

Implementation will occur at national level although the FSB will be responsible for ensuring consistency across jurisdictions

III – Creating a global standard for compensation practices

Compensation practices which lead to excessive risk taking by large financial institutions have now been identified as one of the many contributing factors to the current financial crisis. Furthermore, given the use of significant public funds by national governments to inject capital into failed institutions, the need to reform and restrict compensation practices is now actively being contemplated by many individual nation states.

However, for compensation reform to be not only durable and effective but consistent across jurisdictions, a global supervisory and regulatory infrastructure is required. In our view, the announcement by the FSB that it will implement its predecessor's guidelines on compensation practices offers a potential route to achieving this.

The FSF principles for sound compensation practices are a set of high-level guidelines for banks and other systemically important financial institution to use when drawing up compensation programmes. The principles require compensation practices in the financial industry to be aligned with employees' incentives and the long-term profitability of the firm and call for effective governance of compensation, and for compensation to be adjusted for all types of risk, to be symmetric with risk outcomes and to be sensitive to the time horizon of risks.

In addition, implementation by firms will be reinforced through supervisory examination at national level, although authorities working through the FSF will ensure coordination and consistency of approaches across jurisdictions.

FSF PRINCIPLES FOR SOUND COMPENSATION PRACTICES

1. Effective governance of compensation

- The firm's board of directors must actively oversee the compensation system's design and operation.
- The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.
- Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

2. Effective alignment of compensation with prudent risk taking

- Compensation must be adjusted for all types of risk.
- Compensation outcomes must be symmetric with risk outcomes.
- Compensation payout schedules must be sensitive to the time horizon of risks.
- The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

3. Effective supervisory oversight and engagement by stakeholders

- Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.
- Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

Source: FSF principles for Sound Compensation Practices

The FSF principles provide a framework but no specific detail for how national governments can curb excessive risk taking as part of remuneration programs.

Yet although we welcome the potential coordination of compensation practices at international level, the principles proposed by the FSF are far too broad and lacking in detail. The FSF principles provide a framework but no specific detail on how national governments can ensure that the remuneration programmes of financial institutions avoid excessive risk-taking and reflect sustainable long-term performance.

Increased capital requirements under Basel II rather than explicit regulation may be the most likely contributor to compensation reform

Instead the principles are primarily concerned with reducing the emphasis on short term incentive structures that do not correctly incorporate risk over the longer term. In our view the FSF principles are clearly the first attempt to introduce a regulatory framework for financial institutions. However national governments will still be responsible for its implementation and financial institutions will still be able to determine their own compensation structures including individual compensation limits. Furthermore the FSB has yet to explain how it will reduce regulator arbitrage by enforcing consistency of application across jurisdictions.

Furthermore, the FSB has yet to explain how it will reduce regulator arbitrage by enforcing consistency of application across jurisdictions.

In our view, Basel II, which would require financial institutions to build up more capital reserves, will mean that over the course of the economic cycle financial institutions should have more capital on average and therefore lower profits. We believe it is this rather than explicit legislation which may act as an unexpected contributor to compensation reform in the next few years. The use of Basel II to enforce stricter executive remuneration policies has also been considered by the European Commission, who as we mentioned in the previous chapter have suggested that national supervisors at the global level should monitor remuneration policies at financial institutions, and where they are deemed to be inappropriate or to encourage unnecessary risk-taking, pillar 2 of the Basel framework could be used to force such institutions to set aside additional capital.

Banks must be subject to a framework that links capital to the risk it poses to the financial system

IV – Capturing the macro-prudential drift

The FSB's role as a regulator of the banking industry will certainly add a layer that was missing in the monitoring of individual banks (Basel 2 framework applied by banking regulators) and the supervision of different countries' financial and economic environments (central banks).

The FSB's targets for the banking industry will be to propagate agreed supervision principles and best practice in two key areas: the prevention of financial bubbles and macro-prudential surveillance.

Macro-prudential surveillance is obviously an area where the current framework has not worked. Within the context of the implementation of Basel 2 (launched in Europe in 2008 and still to come in 2010 in the US) the focus was naturally on individual bank supervision. Despite the rapid globalisation of banks and markets, the ultimate responsibility for regulation stayed at national level even in Europe.

Macro-prudential regulation has now become the buzzword for national policymakers seeking to address the financial crisis and there is now a clear consensus that banks must be subject to a framework that links capital to the risk it poses to the financial system.

However, there is little agreement on how the primary weapon of macro-prudential regulation, 'capital adequacy requirements', will work in practice or whether supranational organisations such as the FSB and the European Systemic Risk Council will actually be effective in coordinating this approach or will evolve into mere talking shops. In our view, the successful implementation of macro-prudential regulation appears to be far too dependent on elected officials who may face political pressure to shirk difficult decisions or submit to pressure to loosen tough regulatory conditions during asset price booms.

■ More changes to come

The implementation of macro-prudential supervision does not solve the problem of banks that have become too big, too interconnected and too complex to fail, requiring shareholders and other stakeholders to take greater responsibility for managing risks.

We are currently witnessing a proliferation of proposed solutions to the problems of the financial industry. We think that all areas of the industry will be covered by new or expanded regulation.

REFORMING THE FINANCIAL SECTOR

Changes	CIB	Retail	Asset Management	Private Banking
Macro-prudential supervision	- Limitation of gross positions and hedging - Outliers have to pay insurance premium	- Lower L/D ratios - Outliers have to pay insurance premium		
Micro supervision	- More capital over the cycle	- Anti-cyclical provisions - More capital over cycle		
Regulation scope	- Unification of supervision with commercial banks - Regulation of OTC markets (exchange trading of complex derivative products)	- US specialised banks under the same supervision as banks	- Registration of hedge funds and HF advisers	
Securitisation	- Minimum final take of 5% of securitised assets - Limited day 1 profit recognition for brokers and originators		- Rating of complex structured products separated from plain products	
Governance	- Pricing transparency on stocks (dark pool) and on short selling - Bonus spread over three to five years and linked to medium-term performance with malus for poor performance.	- More power to consumers	- Lobbying of credit rating agencies to include non financial sustainable factors in their ratings	- Tax havens and non cooperative jurisdiction will be on a grey list

Source: CA Cheuvreux

Investment banking

The transformation of the investment banking industry is obvious and the survivors have already rebuilt their models, through derisking and deleveraging. The riskiest part of their businesses could have accounted for one-third of their profits. For the European banking industry this share was much lower, within the 5-10% range. This is due to a limited contribution from CIB (20-30%) and a focus on traditional commercial banking segments.

While investment banks are already deleveraging and redefining their business models, there is a clear push towards higher capital requirements in the medium term, with competition authorities calling for rescaling of businesses, changes to corporate governance and incentives and the redesign of risk management frameworks. All of this will have an impact on capital deployment strategies and the cost of capital. We expect the emergence of an ivy league of investment banks in Europe, comprising Credit Suisse, Deutsche Bank, BNP Paribas. For these banks, we expect a continuing flight to quality that correlates with a higher financial strength perception going forward.

We believe much more transformation is to come, given:

- increased BIS capital requirements for market risks and securitisation;
- new 'buffer' requirements from macro-prudential regulation;
- the requirement by competition authorities such as the European Commission that businesses and subsidiaries should be sold following state support;
- changes to corporate governance and incentives.

The banking industry will need to increase capital so as to improve medium-term capital ratios and repay government debt and capital injection (EUR350bn, mainly through debt qualifying as Tier 1 capital).

The improvement in risk management and monitoring is also key, since one of the lessons of the crisis is the failure of risk models. Previous ones were based on the assumption of significant diversification benefits, which failed to materialise. Both the maths (normal distribution too great) and the inputs (historical correlation too low) were wrong and overestimated the diversification benefits. This will be a major change to the way securitisation works and to the 'originate and distribute' model⁷. This change in models will represent a challenge to current organisations, mainly for universal banking, the most frequent model for the large European banks. Asset management is also an area under review since the relationship between CIB and retail networks needs to be revisited.

Asset management

Asset management will be also reformed, with greater attention on product transparency as shown by the upcoming EU directives on UCITS and hedge funds (banning non-EU registered products). Following recent cases of fraud, open-architecture models will be also challenged, as well as commitments to clients in different and often separate functions of the industry (selling, management, depositary, custody functions, etc).

Retail banking

Retail banking is not immune to criticism and the main issue apart from credit risk management is the monitoring of liquidity. Banks should work with a better balance between loans and deposits, as shown by the dramatic changes made by UK retail banks. Some regulators have already changed the computation of the liquidity ratio, as in France, in order to have a more cautious view.

⁷ A new EU directive was voted by the Parliament in May, which will force the originator to keep a compulsory 5% of securitized assets and this could be increased up to 10% after an observation period.

We expect an ivy league of big banks to emerge in Europe

■ Is it safe for shareholders to re-enter the financial waters?

Shareholders therefore need to recognise the business model of the banks they are invested in, whether retail banks, asset managers, universal banks, or investment banks, bearing in mind the risk/reward profile.

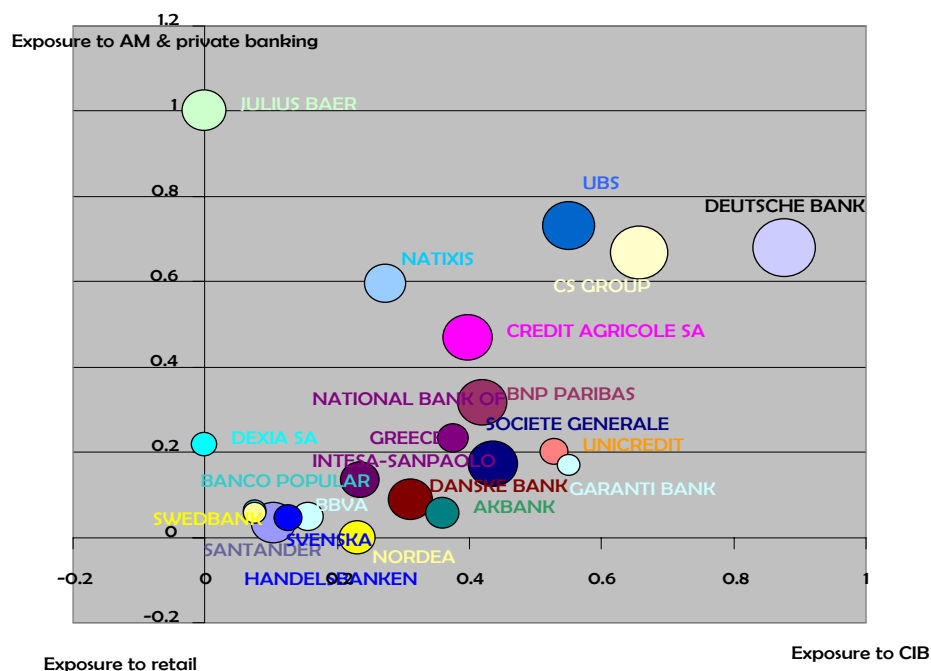
The main risk associated with the current changes in regulation is 'over-regulation', which will diminish the returns of the industry, both through increasing capital requirements and limiting product development.

Therefore in our view investors should favour leaders of big banks such as Credit Suisse, Deutsche Bank & BNP Paribas and Santander. In our view, 'over-regulation' of big banks will sharply increase the importance of the size factor (barriers to entry), and only leaders will have the capacity to invest fast enough to comply with new regulations designed to reduce risk.

In addition we also continue to favour strong banks with the potential to gain market share within their core segments:

- **Winners in Asset Management:** There has been a redistribution in market shares as many banks have been hit heavily on Investment Banking such as UBS, Citibank or Merrill Lynch, which also had strong wealth management (WM) operations. WM franchises with no investment banking exposure and successful growth strategies such as Julius Baer are benefitting from the weakness at these competitors.
- **Restructuring in retail:** in Germany, with regards to Commerzbank and Deutsche Bank (Postbank option), we are still not sure that the (potential) acquisitions will be positive (significant execution risk). We are more positive on BNPP-Fortis (see portfolio of Fortis) but also on Santander both in Brazil and in the UK mortgage segment.

EXPOSURE TO BUSINESS SEGMENT AND TO REGULATORY RISK (size of bubble)



Source: CA Cheuvreux

PERCENTAGE OF 2011 PRE-TAX PROFIT BROKEN DOWN BY BUSINESS MODEL

Bank	Retail	CIB	AM + Private Banking	Others
AKBANK	50%	28%	3%	19%
BANCO POPULAR	87%	7%	6%	0%
BBVA	81%	15%	4%	0%
BNP PARIBAS	42%	31%	19%	8%
CREDIT AGRICOLE SA	41%	27%	36%	-5%
CS GROUP	21%	40%	42%	-3%
DANSKE BANK	62%	28%	6%	4%
DEUTSCHE BANK	8%	57%	17%	18%
DEXIA SA	36%	0%	10%	55%
GARANTI BANK	49%	60%	10%	-19%
INTESA-SANPAOLO	65%	20%	10%	5%
JULIUS BAER	0%	0%	100%	0%
NATIONAL BANK OF GREECE	50%	30%	15%	5%
NATIXIS	32%	12%	46%	10%
NORDEA	73%	22%	0%	5%
SANTANDER	87%	10%	3%	0%
SOCIETE GENERALE	49%	38%	10%	3%
SVENSKA HANDELSBANKEN	83%	12%	4%	1%
SWEDBANK	86%	7%	5%	2%
UBS	22%	27%	59%	-8%
UNICREDIT	40%	45%	10%	5%

NB: Cheuvreux's European Bank Top Picks are highlighted in bold.

Source: CA Cheuvreux

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