

## **Contribution by Prof. Teixeira dos Santos on the hearing on 10 July "After Enron: financial supervision in Europe"**

**1 - Do you consider that all financial players are adequately covered by prudential rules/supervisor? Do you see any possible gap or overlap in the current arrangement between European regulators?**

In so far as supervisory failures due to regulatory “holes” are, at present, foreseeable, the answer to this question is affirmative, taking into consideration the fact that the introduction of the directive on financial conglomerates has reinforced existing supervision in the sector in question.

Considering European regulators in terms of the concept applicable to regulators of the activities of the securities, banking or insurance sectors, the possible overlapping of supervisory duties is resolved by the capacity of regulators to determine the relevant contribution made to prudential supervision. Whenever there exists an effective and efficient capacity to transmit information, such overlapping is not problematic.

**2 - Is it possible to define a truly “European touch” in financial regulation and supervision or do you think priority should be given to defining rules at the global level in instances such as the Basle Committee or the International Association of Insurance Supervisors?**

Supervisory approaches vary substantially in this area, with European regulators typically being more in favour of a more demanding, consolidated approach than their counterparts.

In the European Union, a draft directive is currently being discussed regarding the consolidated supervision of financial conglomerates, in order to address the supervisory concerns which may arise with regard to intra-group transactions and concentration of risks, such as the risk of contagion, of conflicts of interest between the various parts of the group, of supervisory arbitrage where a business line could be transferred to a less regulated entity within the group and the lack of a comprehensive overview of the exposure to risk within a group. This European directive would, however, only cover entities based in Europe. Discussions have also taken place at the Joint Forum with regard to these issues. IOSCO has also started work on an important project aimed at eliciting regulatory responses to these important issues, in particular from Standing Committee n° 3 (SC3).

However, both *fora* deal merely with financial conglomerates, i.e. groups of enterprises, the activities of which mainly consist of providing financial services. The issue of industrial conglomerates with significant but not predominant financial activities remains yet to be addressed.

As a point of reference, it seems important to have a harmonised set of principles to define the scope of financial regulation and supervision around the world, since we may not say that a group operates only in Europe, but rather has an impact all over the world. Bearing this in mind, we wish to consider two levels of approach: 1 – harmonisation in accordance with the Commission’s Action Plan for Financial

Services – with attention focused mainly within the EU, since this is a priority ; 2 – extending these concerns to the rest of the world in order to obtain a common set of principles on this matter – this could be achieved not only at the level of the Basle Committee or the International Association of Insurance Supervisors but also taking into consideration developments taking place at IOSCO level, particularly in matters of coordination related with supervision on operational risk .

**3 - Against the background of the Enron and LTCM cases (non-banks which are nonetheless able to influence strongly financial markets), do you think there is a need to strengthen supervision of non-banks (and non-insurance companies in Europe)? How?**

In order to justify regulation/supervision, it is necessary to specify two separate sets of interests: the protection of consumers and of the system. In order to protect consumers it is necessary to act as regards rules for disclosure, thus increasing transparency. In order to protect the system, it is necessary to evaluate solvency (capital adequacy) and to verify the intervention of counterparties.

The first of these priorities will, without a doubt, affect certain rules regarding transparency, corporate governance, financial reporting to the market and the role and performance of auditors. These questions inevitably lead us to the need to re-consider and weigh up all corporate legislation, so as to allow us to modernise legislation governing the operation of companies. It thus becomes important to create incentives and to follow up work currently being carried out with regard to this question, in particular “Corporate Governance and the role of the European Union”, drawn up by the *High Level Group of Company Law Experts* (Report of Jaap Winter – chairman of the high-level group of company law experts, the index and mandate of which were reviewed by Ecofin on 4/6/2002). Also of great importance is the issue of Special Purpose Entities, both with regard to the consolidation of the assets and liabilities on company balance sheets (covered by the new regulation which adopts IAS for listed companies and modernisation as set down in the draft proposal on modernisation of accounting directives for other companies) and with regard to the effect that such SPEs may have, namely a reduction of transparency as regards qualified holdings in public companies (which makes it necessary to study the adoption of certain measures in order to identify the beneficial owners of such SPEs, inspired, to a certain extent, by the objectives of the BCCI Directive).

The second priority mentioned above, which extends to risks inherent to the proper operation of the financial system, referred to as systemic risks, should be regarded as being at the heart of the financial system. If entities regulated in the context of the financial system act diligently, adequately covering their business risks and making investment decisions based on economic rationale, and complying with prudential rules to the extent which is adequate to their activity, the probability of other entities (acting outside the system) affecting the system in question, is reduced.

Supervision should always remain focused on members integrating the financial system, thereby ensuring the stability of the same.

Rather than simply going ahead with further supervision of entities outside the financial system, it is more relevant to re-think existing legislation on corporate

governance, with a view to ensuring that this provides an adequate response to the needs arising in these new times, especially with regard to medium and large enterprises.

**4 - How is it possible to combine rules (officially, the Commission considers the financial sector as a conventional sector without specific rules) and prudential rules? Is there a trade-off between competition and stability of the financial sector?**

It is certainly true that, in the financial sector, the existence of a certain level of agreement between competition and financial stability is fundamental. However, financial stability must dictate the level of competition allowed, with attention being paid to the systemic risk to the economy which could arise from instability in the financial sector (in the knowledge that the opposite may also happen).

**5 - A number of large European banks and insurance companies are conducting a significant share of their operations in emerging markets, where risks are higher and supervision from emerging markets regulators is, admittedly, less effective. How can supervisors and regulators be able to monitor effectively of financial groups overseas?**

On principle, all countries should possess systems which ensure adequate supervision, based on common principles which allow a reasonable level of security to be achieved with regard to the operation of the financial system on an international scale. The closest supervision of companies is that which guarantees, from the start, the greatest possible supervisory efficiency, taking into account a knowledge of the local realities involved and of the way in which the respective economy operates and of the working culture of the market in question.

The sharing of information should be encouraged, through memoranda of understanding, with similar importance and particular value being given to the willingness to collaborate demonstrated by the countries in question.

The European Union could also contribute to the provision of training for local supervisory bodies in emerging countries, on a basis related to protocol which ensures cooperation from these bodies on the matter of enforcement in which bodies operating in these countries are involved.

Should existing supervision be inadequate, or inexistent, the confidence inspired by the local supervisory body would not be sufficient, in which case it would be necessary to supplement it by means of adequate supervision carried out on a centralised basis.

The new proposal for a Directive on financial conglomerates strives to provide an efficient response to these questions.

However, it has become necessary to take action in the sphere of cooperation, so as to allow the E.U. to benefit from the sharing of information regarding supervision, extenuating the costs which would arise from the development of centralised supervision, with the risk of greater detection.

**6 - Would it be necessary to create a European database of financial institutions filled with prudential data accessible without formalities to all national supervisors (and only them of course) in order to facilitate the flow of information between national regulators?**

This necessity is proportional to the incapacity of supervisors to inform their counterparts and to coordinate efforts to defend the higher interests of the economy and the markets.

In so far as the capacity to act during working hours exists, the need for a data base for this purpose decreases, because in this case it is necessary to weigh up the respective costs of its development and maintenance.

**7 - The rating will have to play a larger rule in the future reforms of capital adequacy whereas they were not really good at forecasting the Enron crash. Do you consider them a source of reliable data?**

The Enron affair constituted fraud, a fact which significantly impedes any analyst attempting to carry out of an error-free analysis of the company.

Rating agencies are, by definition, analysts, albeit specialised ones, whose objective is to provide a benchmark – rating – to the company under analysis or to a financial instrument issued by the company in question.

In accordance with the Directive on Market Abuse, no exception has been contemplated as regards access to privileged information by rating agencies. This situation is correct, since a company which is downgraded must divulge the underlying events to the entire market. It should be pointed out that rating agencies also market information on ratings produced, which creates the risk that price sensitive information may be distributed among clients of rating companies (through a downgrade in a company's rating) before the rest of the market becomes aware of this.

Considering these limitations, there is no reason why we shouldn't continue to have faith in ratings given, as long as the impartiality of the rating agency is guaranteed, as well as the coherent application of standards and analysis procedures.

It should also be noted that these companies assume a relevant role in the evaluation of securities and constitute one of the essential elements of the application of the Basel II Accord.

One must consider the fact that some form of regulation of rating agencies may be necessary, particularly as regards the quality of the work they carry out and the conditions of impartiality which must preside over the carrying out of the same.

Even if this does not eventually lead to deeper intervention, the possibility of creating a Code of Ethics applicable to rating agencies may be weighed up.

## **Specific questions**

**1 - Is it possible to talk about prudential supervisions of UCITS in the same way as in banks or insurance supervisions? Are UCITS liable to specific risks?**

It would seem hasty to place the prudential supervision of UCITS on the same footing as that of banks or insurance companies. Given that the challenges posed by this

supervision of UCITS are growing, in reality this is still a long way off, particularly in terms of the second leg of the Balance Sheet and extra-patrimonial accounts. However, supervision of hedge funds (or the need for this) may be very similar in nature to that which exists for banks and insurance companies, as recent times have shown. The specific risks of funds continue to be mostly related to financial markets (money markets, exchange markets, securities and financial instrument markets) and capital invested is also, for the most part, a fund's own capital.

**2 - Against the background of the creation of a single financial supervisor in some European countries, what are the reasons to let the supervisor responsible for conduct of business rules separate from supervisors responsible for banking and insurance supervision?**

The main reason is the result sought by the type of supervision in place. While behavioural supervision (conduct of business rules) is concentrated on the disclosure of information to investors, in order to help them make decisions which are hopefully rational ones, prudential supervision concentrates on creating the necessary conditions to ensure that the financial situation of companies targeted is not jeopardised by the rational decisions of their investors. The bringing together of both types of supervision poses the risk of one of them being disregarded, which would in turn jeopardise the proper working of economic agents.

**3 - Against the background of the Enron affair what would be the most urgent reform to implement in securities markets to prevent another Enron case? In such a case possible in Europe? Why?**

The Enron affair revealed certain weaknesses in the world's largest securities market which, it was thought, would be the model to be followed as regards de-regulation and the provision of adequate means to ensuring greater responsibility on the part of all agents of the said market, based on self-regulation (either by market agents themselves or, in the case of auditors, by the profession itself).

These weaknesses stemmed from the fact that, in the first case, when fraud and collusion occur, they are extremely difficult to detect. However, the probability that fraud exists invariably depends on the levels of safeguards which exist. In effect, existing safeguards, at the level of corporate governance – as regards the internal workings of companies and supervision carried out both within the respective companies and on auditors, left exclusively to a system of peer-review, without the intervention of independent bodies – have proven to be weak, meaning that there is a greater risk of cases such as this happening.

Greater attention is paid to these matters in Community law, since it is based on multi-cultural discussion, arising from very useful debate which enriches the final product. These are the characteristics which permit the European Union to obtain a more balanced legislation which allows it to respond to the diverse questions which arise.

However, in certain matters, given the age of certain Directives, it is important to proceed with a process of modernisation, especially in light of the rapid evolution of society as a whole, giving rise to the increased complexity of relations between companies and growing globalisation.

From this perspective, which arises not just from the Enron affair, but was given greater salience by the existence of this case, the following procedures are now of the utmost importance:

- The revision of company law on corporate governance, the role of Audit Committees, their establishment, the qualifications of their members and the mandate governing their actions;
- The revision of the 8th Directive and of existing safeguards, with a view to ensuring that the role, activities, statutes and responsibilities of auditors satisfy the expectations of the markets;
- Assurance that all Member States, and the respective bodies responsible for supervising financial information disclosed by listed companies and by other bodies of high public interest, possess the same enforcement capacities, both in terms of powers and activities based on standard principles, thus preventing vulnerability to supervisory arbitrage.

**4 - As chairman of the Portuguese security supervisor you are member of the Committee of European Securities Regulators (CESR). How do you assess the degree of cooperation between regulators? Do you consider now that information flow swiftly between national regulators in Europe? Are there any possible improvements of the current procedures? And how do you see the interaction between the European Commission and the national regulators when implementing Lamfalussy' style directives? Is there a risk of confusion between level 2 and level 3 in the current scheme?**

Not only as a member of the CESR, but, in particular as Chairman of the CESR's Expert Group on Prospectus Disclosure Requirements, I have had the opportunity to bear witness to the first steps of this regulatory model, which we have worked together to implement, having learnt of the proposals of the Committee of Wise Men and having reached the necessary level of inter-institutional agreement on a European scale.

Based on this experience, and in line with what has already happened with FESCO, I have not encountered anything which blocks the fundamental exchange of information between Supervisors in the EU. European securities markets, which are becoming more and more integrated, impose efficient and credible procedures for cooperation on the matter of supervisory structures. Both from a bilateral and a multi-lateral perspective, at EU level, it is my belief that nowadays we enjoy an adequate system for the exchange of information and supervision practices. Naturally, this system can and should be constantly improved through the experience gained on the ground and from the evolution of the activity of the markets. The work of the CESR - at the level of Enforcement (via CESRPol or the Enforcement Sub-Committee belonging CESRFin), on the disclosure of financial information to the markets, (via CESRFin) and, to a certain extent, the implementation of the Market Abuse Directive - has justified my optimism as regards the future of this area.

While presiding over the aforementioned CESR group on prospectuses, I have worked, in close conjunction with the European Commission, towards the establishment of Implementation Measures for the awaited Directive on Prospectuses. The delay in approval of the Directive (level 1) could imply that we have been confronted with a certain degree of disorientation or tensions as regards relations between the CESR and the European Commission (as well as the rest of the European Union's Institutions), given that, as is widely known, we have been working on technical advice for the European Commission, in the context of level 2 Implementation Measures. On the contrary: always guided by the fundamental rules of transparency and institutional cooperation, we have succeeded in making directives more extensive and outlining the scope of solutions to cross-border problems as regards offerings of securities and, hence, have contributed to the greater integration of the European market, from the perspective of regulatory models and supervision. Speaking from a personal point of view, ties between the CESR and the European Commission have been excellent throughout these first few months of implementation of the new model. The mutual assistance provided between the Committee and the Commission, as well as the contact maintained with the securities Committee and the European Parliament, through the EMAC, have provided an excellent atmosphere of cooperation between the various *fora* involved. This allows me to look with confidence towards the near future.

In this context, we must not, however, forget the inevitable difficulties with which we are faced. In this respect, the distinction between level 2 and level 3 assumes great relevance. Confronted with the necessity to propose implementation measures in the area of the Directives on Market Abuse and Prospectuses, the CESR has reflected on the matter in question and, together with the community institutions, has sought to base these on the common practice of outlining the measures involved in these two levels. For the time being, and at the risk of making the process overly rigid, it seems clear to me that a sense of pragmatism and casuistry must prevail, with close attention being paid to the circumstances of each concrete case. The inevitable uncertainty arising from this distinction will definitely be minimised, if not altogether neutralised, thanks to political dialogue to be carried out between the Committee and the other principal regulatory bodies of the EU and through technical dialogue between regulators and supervisors, firmly based on the regulatory experience gained in the fifteen jurisdictions during the last two years. With the progress made by the CESR as regards the implementation measures of the Directives on Market Abuse and Prospectuses, it is highly possible that greater practical clarification of the distinction between level 2 and level 3 will be achieved as early as the second half of 2002.

It is always possible to perfect already existing procedures and to implement new routines for cooperation which, at an operational level, guarantee the efficiency and consistency required if we are to face up to new supervisory and regulatory challenges.

As regards the improvement of existing procedures, I believe that it is possible and necessary for us to continue to work towards the perfection of contact lists and data bases through which European supervisors can monitor those responsible for supervision under the jurisdiction of each regulator, as well as providing their respective means of contact. I would like, at this point, to highlight the good work carried out by CESRPol and CESRFin which, based on cooperation structures

inherited from FESCO, have reinforced cooperation by developing formats for different areas of supervision.

Even if, as regards the question of the flow of information among supervisors, I believe that there is still room for improvement, throughout the EU, of the articulation of inter-sectoral information related to prudential supervision, perhaps through the experience gathered during the development of contingency plans such as those following the events of 11 September (having also been verified in the case of the Financial Stability Forum and IOSCO).

In relation to the implementation of new procedures which guarantee the optimisation of structures and routines which have been implemented in previous years, I am convinced that the tension between the need for speedy, yet high-quality supervision by regulatory and supervisory authorities will ensure that we are always attentive to new demands and, thus, to new solutions and responses to global problems. The sophistication of the markets has stimulated interesting discussions by the CESR which, I am convinced, will not fail, in the short term, to encourage the implementation of procedures to reinforce cooperation between European supervisors, taking advantage of level 3 procedures in order to ensure an effective application of agreed measures, thereby reducing the risk of supervisory arbitrage.