EUROPEAN COMMISSION
Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS
Financial services policy

Brussels, 11 November 2009

NOTE TO THE FINANCIAL SERVICES COMMITTEE

Subject: Third Countries dialogues update

This note presents the state of play as regards regulatory dialogues with the US, China, Russia, Japan, India and Brazil.

In 2009, as a result of the financial crisis most countries covered by the regulatory dialogues have entered into an intense phase of regulatory activity in the financial area. The G20 and its regulatory arm, the Financial stability board (FSB) have provided the multilateral platforms for the co-ordination of global efforts to reform the financial sector. In addition, the regulatory dialogues between the European Commission and key partners in this area have offered useful, flexible and informal bilateral platforms to mutually exchange information, identify potential regulatory conflicts and work out solutions. The EU-US Financial markets regulatory dialogue (FMRD) in particular has provided a robust and efficient platform for bilateral discussions. In the current context, EU regulatory dialogues with Third countries are likely to have a growing role in addition to the FSB work to ensure that the implementation of the commitments of the G20 by their participants at domestic level are as compatible and as convergent as possible.

US

Three meetings of the FMRD took place between end 2008 and end 2009 (December 2008, June 2009 and October 2009). FMRD participants have had numerous additional informal meetings, calls and exchanges on financial regulatory issues. In addition, several high level meetings were organised, with the visits of Commissioner McCreevy to the US in December 2008 and June 2009 and the visits of DG Jorgen Holmquist to the US in April and September 2009.

The US and the EU have quite convergent agendas for financial regulatory reform, as shown in the roadmaps put forward in the EU Commission Communication of 4 March 2009, "Driving European recovery" and in the US Treasury "White paper on financial regulatory reform" of 17 June 2009, which in both cases are in line with the successive commitments of the G20 and Financial Stability Board (FSB) members on regulatory reform. Both roadmaps have now entered into their implementation phase. However, due to different legal, cultural and historical traditions in the financial sphere, different lawmaking process and different timing, such convergence of purpose and objectives does not, ipso facto, guarantee that overlap, duplication or spill over effects can be avoided. The EU and the US are aware of these risks and acknowledge that, because of the strategic importance and the high degree of interconnectivity of the transatlantic financial marketplace, it is essential to pursue the maximum degree of convergence with the US to reform financial regulation to avoid fragmentation and regulatory arbitrage. As our respective regulatory reform roadmaps continue to unfold, the participants to the FMRD will continue to hold regular exchanges of information at all levels and monitor closely regulatory developments on both sides of the Atlantic.

State of play of the FMRD on main files:

Credit Rating Agencies

The crisis has demonstrated the need to reform the regulation and supervision of credit rating agencies (CRAs). The EU agreed a regulation on CRAs last Spring. US Treasury's proposed legislation is currently under consideration in Congress. There have been extensive contacts between both sides on the issue of equivalence. European Commission officials travelled to Washington to meet with the US Securities and Exchange Commission (SEC) and US Treasury in July. The Commission has mandated the Committee of European Securities Regulators (CESR) in June 2009 for technical advice on, inter alia, the equivalence between the legal and supervisory frameworks of the US, Canada and Japan applicable to credit rating agencies which is one of the requirements of the EU Credit rating agencies regulation. On the basis of this advice (to be issued before 15 February 2010), the Commission will prepare a measure to be adopted through comitology.

Derivatives

Both the U.S. and the EU agree that it is critical to make progress on derivatives to ensure greater financial stability. Both sides share the view that reporting all OTC derivative contracts to trade repositories, clearing all standardized contracts through central counterparties and shifting trading of standardized contracts onto exchanges/electronic platforms where appropriate, will significantly reduce risk and improve transparency within the financial system. US Treasury's proposed legislation is currently under consideration in Congress. On 20 October 2009, the European Commission released more detailed policy proposals regarding OTC derivatives. Both sides continue to work together to share experiences and coordinate approaches as evidenced by the New York Federal Reserve-chaired OTC Derivatives Regulators Forum and the September visit of CFTC Chairman Gensler to Brussels for the European Commission High level conference on Derivatives Markets.

Alternative Investment Fund Managers

One of the early commitments of the G20 was that supervision of hedge funds and alternative investment fund managers should be enhanced. US Treasury has forwarded proposed legislation to Congress, calling for registration, reporting and disclosure requirements for managers of hedge funds and other private pools of capital, along with prudential requirements for systemically significant funds. This proposed legislation is currently under discussion in the Congress. The European Commission tabled its proposal in April 2009 which would require authorization and apply prudential and other requirements to alternative investment fund managers. This proposal is currently under discussion in the European Parliament and the Council. Both parties have had numerous exchanges on their respective proposals, both in the FMRD and in bilateral meetings in Washington and Brussels. EU and US authorities agree that it will be important to make progress in the period ahead in order to allow alternative investment managers to pursue global strategies on the basis of sound management practices, in particular with regard to risk management, and high quality standards.

Accounting

An important commitment from the G20 in Pittsburgh is the need to achieve a single set of high quality, global accounting standards. The SEC is currently evaluating responses to public comments on its proposed roadmap for potential use of International Financial Reporting Standards (IFRS) by U.S. issuers. The European Commission is seeking clarification of the SEC's stance on this issue, which is overdue. The European Commission is strongly supporting closer cooperation between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to ensure convergence and a level playing field between the EU and the US on a certain number of key issues, in particular in relation to the accounting treatment of financial instruments. However, convergence should not come at the expense of high quality standards. The Commission is examining phase I of the IASB's proposals on the classification of financial instruments with stakeholders.

Auditing

Work has been continuing to find a satisfactory solution to the issue of sharing confidential audit papers among official auditor oversight bodies. Discussions are currently taking place to address short term concerns between the European Commission, the Public Company Accounting Oversight Board (PCAOB), the SEC and the US Treasury. The U.S. re-affirmed that it is seeking necessary legislative changes to ensure a long term solution to the issue. An amendment to Sarbanes-Oxley that would allow the PCAOB to share information with foreign supervisors has been submitted, both as a standalone bill and as part of the Investor Protection Act of 2009, (itself part of the U.S. regulatory reform proposals). This amendment, if adopted in its proposed form, would allow the European Commission to include the PCAOB in a decision allowing EC Member States to exchange audit working papers with other official auditor oversight bodies.

Insurance

Work is continuing to seek resolution of outstanding issues for U.S. and EU insurance companies operating in each other’s jurisdiction, including focus on reform of the collateral rules applied to EU and other third country reinsurers that are not licensed in the United States, on proposals in the United States to create a national insurance office within the US Treasury and and on proposals regarding the treatment of third country insurers and reinsurers in the EU Solvency II Directive.

G20 / Financial stability board

Exchange of information and discussions are taking place upstream within the FMRD on issues discussed in the G20 and the body in charge of the G20 financial regulatory agenda, the Financial Stability Board, in particular in relation to the strengthening of international standards and their implementation. This is in particular the case with bank capital rules (e.g. improving the quantity and quality of bank capital, discouraging excessive leverage or mitigating procyclicality), accounting standards (cf supra) or compensation within the financial sector.

China

Due to lack of availability of the Chinese authorities, only one meeting took place at the end of November 2008. At that 4th EU-China financial dialogue, there was a common understanding to move towards greater regulatory cooperation in specific areas. In this context, the Commission and its Chinese counterparts have put in place working groups on insurance, auditing and accounting issues and could move in the same direction in the banking and securities sector. The next meeting of the Financial Dialogue was scheduled to take place in Brussels on 16 November 2009, but was postponed at the request of the Chinese authorities. It should take place at the beginning of next year.

The banking sector is one of the main focal points of our dialogue as there is a very strong interest from EU industry. While there are some 70 European banks active in the Chinese market with different levels of presence (subsidiaries, branches and representative offices), the market share of foreign banks remains limited (under 3% of assets). Our dialogue concentrates on prudential issues: financial crisis, implementation of Basel II, prudential regulation in China for foreign banks (branches and subsidiaries). We are also addressing the licensing process and the limited scope of business for foreign locally incorporated banks and branches. Finally, the 20-25% investment cap in Chinese banks remains a very serious impediment for the development of EU banks on Chinese markets. It must be noted that Chinese banks have largely been spared from the troubles suffered by their Western pairs and are reporting good financial results. However, the current lending increase of the last 12 months might result in an increase of non performing loans. Chinese regulators' are concerned about the potential deterioration of credit quality and have reacted by increasing provisioning and higher capital ratios and announcing tighter rules for personal loans.

Concerning capital markets, the China Securities Regulatory Commission (CSRC) is working on a number of welcome reforms. China's capital markets continue to develop, in particular with a substantial increase in bond issuance in the last few months, the easing of restrictions by the China Insurance Regulatory Commission (CIRC) on insurance companies' investments in corporate bonds, the launch of ChiNext, an alternative investment market for start-ups similar to AIM, Alternext or NASDAQ, an upgrade of QFII (Qualified foreign institutional investors programme for foreign investors to invest in the Chinese stock market)rules and new QDII (Qualified domestic institutional investors programme for Chinese investors to invest in overseas markets) licenses. Against the backdrop of the economic recovery, IPO activity has resumed and the Shanghai composite index continues to rise and is now up 65% for the year. The securities foreign joint ventures licensing process has been reopened but only a handful of licences with limited business scope have been granted up to now. A new foreign securities Joint Venture, with the participation of Deutsche Bank, was approved in July.

These trends are welcome but further opening to foreign business should be accelerated.

The insurance sector is currently enjoying rapid growth rates especially in the retail insurance business. The Commission held several rounds of discussions with the CIRC focusing on Solvency II, the role of private pensions and market access related issues. As regards the latter, the Commission has voiced concerns about the closure of compulsory motor insurance business to foreign undertakings, the access to corporate annuity and pension insurance business and the burdensome licensing process. Finally, the 50% cap on foreign investment in life insurance is also detrimental to foreign insurance companies which would like to participate more in the growth of the insurance markets.

Sovereign Wealth Fund (SWF) issues are also particularly important and the Commission is monitoring closely the developments in this area. CIC, China Investment Corporation, accepted the invitation to attend the OECD Investment Committee and has so far been an active observer.

Finally, it must be noted that China has been an active player in the international arena playing an important role to build consensus around the G20 summits. China's increasing financial strength and growing role as a global player clearly underscores the need for China to continue modernising and opening up its financial sector.

Russia

Two meetings took place this past year (November 2008 and October 2009). The fourth meeting of the EU Russia Dialogue on Financial and Macroeconomic Policy took place in Brussels on 13-14 October 2009, a few weeks after the G20 summit in Pittsburgh. The follow-up to G20 decisions took centre stage. The Russian representatives expressed support for almost all G20 measures, with the exception of executive pay. Possible exit strategies from large fiscal and monetary stimulus measures were also discussed. The regulatory part of the dialogue was largely dedicated to banking, insurance, and securities issues. Corporate governance and free movement of capital issues were also shortly discussed. Russia presented draft elements of a possible insurance sector reform (e.g. possible introduction of a more risk-based approach and a higher protection level for consumers). Russia also delivered an update on a number of legislative initiatives in the area of derivatives.

Both sides agreed during the meeting to reflect on ways how to improve the dialogue's effectiveness further. The EC side suggested focusing technical work at working group level in future. Issues requiring further discussion could then be brought to the attention of the high level during the annual plenary session. This structure would allow establishing a more focused agenda and would also grant additional time for more informal exchanges between plenary participants. Russia's initial reaction to the proposed changes seemed positive.

Both parties agreed also in priciple on the setting up of an additional regulatory working group on banking and securities by mid 2010, though details still need to be hammered out. This group would complement the two existing ones on accounting & auditing and insurance. More regulatory cooperation between the EU and Russia is considered essential in view of the latest G20 and FSB developments. A working group on macroeconomic issues is also under preparation, though its exact title still needs to be defined.

The next meeting of the Financial and Macroeconomic Policy dialogue is expected to take place in Moscow in autumn 2010 (a precise date has yet to be defined).

Japan

The High Level Meeting on financial issues took place in Brussels in April 2009 between the Directorate General for Internal Market and Services and the Japanese Financial

Services Agency (FSA). A very open dialogue enabled exchanges on the financial crisis, its impact in both Japan and the EU and the follow up to the G20 summit. Both sides presented recent policy developments and exchanged views concerning the functioning of the G20 and the FSB, economic stimulus and market supervision. Special attention was given to the revision of the Financial Instruments and Exchange Law in Japan and potential impact on EU securities firms and trade of EU government bonds, as well as on the new EU regulation on credit rating agencies and the equivalence of third countries regulatory framework. Discussions also focused on accounting, audit, and the results of the first sectoral dialogue on insurance held in January 2009. The next HLM will be organised by the FSA and the Ministry of Finance in Tokyo during the first semester 2010.

In the future, specific attention will be given to recent amendments to the Financial Instruments and Exchange Law; recent reforms addressed in particular the relaxation of the firewall system, trust banking, and the reinforcement of principles-based regulation. The FSA should adopt guidelines regarding information sharing and reasonable inter-locking of executives. Universal banking should remain the long-term goal. Attention will also be paid to upcoming ordinances on secondary distribution of securities in Japan. As regards insurance, the European Commission will reiterate its requests to eliminate the differing treatment applied to Kyosai (cooperatives selling insurance) and submit them to FSA supervision. The European Commission will also underline the need to further promote better regulation, including when carrying out crisis response measures. FSA committed to improve communication with stakeholders and cooperation with the Central Bank of Japan. Strengthened transparency and consistency in the implementation will determine whether the reforms will have positive impacts on the financial services industry and consumers.

Concerning accounting and auditing issues, the EU and Japan are involved in a process to move towards mutual reliance on each others' regulatory systems. On auditing, the European Commission decided in August 2008 to grant Japanese audit firms a transitional period until July 2010 for their registration in the EU. The FSA adopted a framework for inspection/supervision of foreign audit firms in September 2009. The European Commission will follow the implementation of this framework, and whether the nine relevant EU oversight bodies are recognised as equivalent. The European Commission will also move forward regarding exchange of information with FSA. On accounting, Japan is encouraged to accelerate the convergence process and to move to the International Financial Reporting Standards (IFRS) as soon as possible. FSA endorsed in June 2009 a decision regarding the possible mandatory use of IFRS as of 2015 or 2016.

In addition, regular exchanges of views have been conducted with FSA during 2009. In September – October 2009, the Commission provided further information on MiFID, quality of OTC derivative markets, deposit guarantee schemes and on new proposals on financial supervision and AIFM. Recent concerns in Japan appear to be twofold: on one hand how to put in practice the fledging programme of the new Hatoyama's government, one the other hand how to implement the G20 action plan and FSB recommendations. The priority will remain to continue two-way exchanges of information based on mutual trust regarding the developments of regulatory and supervisory frameworks. The European Commission will participate when appropriate to public consultations launched in Japan.

India

A first meeting of the EU India/ dialogue was held in June 2006 in Brussels with the Indian authorities. It was an occasion to exchange information on regulatory and supervisory policies in financial services sectors and for India to present its financial reforms. It focussed on company and accounting standards, financial services policy and overview of financial institutions.

Despite our willingness to organize a second meeting, and several attempts to re-launch the dialogue in 2008, no agreement could be found on a date. However, at the last EU-India macro-economic dialogue held in Delhi on 30 October 2009, the Indians finally agreed to hold back to back with the next macro-economic dialogue the 2nd EU/India dialogue, probably around October 2010 in Brussels.

In the meanwhile, several missions of Commission officials to India have yielded interesting results such as a dialogue on accounting and auditing. These missions have also confirmed the political interest of the Indian Ministry of Finance to engage in a comprehensive dialogue on financial services. The Commission will continue to invite Indian counterparts to engage into a deeper dialogue on financial services to address the regulatory issues faced by our respective financial services industry. Despite recent reforms, it is particularly important to maintain pressure so that further reforms could be implemented rapidly especially in the banking and insurance sectors. It will benefit the entire Indian economy by fostering a better capital allocation.

Financial services reforms started in India in the early nineties with a slow liberalisation of the banking activities, increased disintermediation, a relaxation of many restrictions to provide operational flexibility and improve efficiency, the strengthening of the legal and prudential frameworks and the introduction of more competition from private and foreign banks. The supervision structure is divided between the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI) and an insurance supervisor (Insurance Regulatory and Development Authority (IRDA). However, the pace of reform remains slow, and the presence of foreign financial services companies limited, especially compared to the potential of the Indian markets.

Demand for domestic banking services in India is growing strongly over the last 4 to 5 years. The total assets of scheduled commercial banks have more than doubled between FY04 and FY08. The rapid expansion of the economy has also meant that the appetite for credit during recent years is also high. India's banking sector is still heavily dominated by public banks. India currently has 77 Scheduled Commercial Banks (SCBs) - 27 public sector banks (Indian Government holdings), 22 private banks and 28 foreign banks. They have a combined network of over 53,000 branches. It is estimated that India's public banks hold over 75% of total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5% respectively.

Concerning securities and capital markets, India has modernised its markets and international investors have been increasingly active. However, the corporate bond market is at an early stage and will need to develop much further. This could be an important drag on a sustainable Indian growth as more and more Indian companies will need to access competitive financing instruments. Equally important is the development of an investment funds industry to support the growth of equity and debt markets. Despite the impressive growth of the Indian stock exchanges, the industry is still in its infancy and dominated by local players.

One of the main obstacles to foreign financial services firms on the Indian market remains the foreign cap of 26% in insurance. This cap should rise to 49%, but the Indian government has not yet confirmed when this will occur. As of July 2009, the new congress-led government in India appeared to have at least postponed plans to liberalise foreign direct investment rules in various sectors, including insurance and banking.

Brazil

A first meeting of the EU-Brazil Dialogue on Financial Services took place in Rio de Janeiro and Brasilia on 19-20 October 2009. Main counterparts for this dialogue are the Securities Regulator (Commissão de Valores Mobiliarios - CVM), Central Bank of Brazil and the Ministry of Finance. Side meetings also took place with BM&F BOVESPA (the main Stock Exchange), Banco Santander, Deutsche Bank and the Brazilian Institute of Corporate Governance. Though Brazilians seem quite confident that their regulatory and supervisory framework is efficient, their regulators are observing very carefully developments taking place in the EU and the US. It was agreed that the dialogue should continue at various working levels. Both sides see the dialogue as a continuation and a complement to the G20 discussions. Next steps will be a videoconference with the securities regulator (CVM), the Central Bank and the Ministry of Finance, to be organised at the end of January/beginning of February 2010.

Financial services are quite extensively regulated in Brazil (with some exceptions like CRAs or corporate governance issues) and subject to various layers of regulation and supervision. As an example, Brazil is more advanced in respect of the regulation of hedge funds than the EU, despite the fact that private equity is not regulated.

Securities

In the securities sector, all possible trading venues are covered by regulation. Rules are very strict and aply equally to domestic and foreign entities without discrimination. Brazilian regulations force brokers to provide information on every trade executed by every client. This is true not only for equities trade at Bovespa, but also of OTC derivatives, which must all be registered at the BM&F. In order to improve the situation in derivatives markets in line with international discussions, CVM does not envisage mandatory CCP clearing but is rather in favour of using capital requirements.

Rules governing the fund industry are similarly strict (mandatory registration, mandatory disclosure of investment strategy).

In contrast with other areas, credit rating agencies are not regulated in Brazil. CRAs in Brazil are about to update their internal codes to reflect to the reform of the IOSCO Code on CRAs issued in 2008. However, the CVM has not excluded regulation in the field of CRAs, and is observing closely developments in the US and the EU. The importance for Brazil to move forward with regulation was highlighted by the Commission, notably in order for the subsidiaries of the "big 3" in Brazil to be able to use the endorsement regime provided for in the CRA regulation.

Banking

On banking, discussions focused on capital requirements/buffers, provisions and reserves.

After significant restructuring in the late 1990s, Brazil's banking sector is well capitalised, well regulated and subject to draconian supervision, notably during the crisis. As a result, no bank was threatened with insolvency or bankruptcy.

Full implementation of Basel II is scheduled for no later than 2012. Brazilians support the Basel Committee to move quickly on the validation of internal models, on recalibration of the standardised models and on capital buffers. Capital buffers are essential for Brazil in terms of ensuring a sound banking system.Both sides agreed that various legal forms should be acceptable provided that the capital is immediately available and has the capacity to absorb losses. On pro-cyclicality, the approach adopted by Brazil is similar to the one followed by Spain on dynamic provisioning. Concerning the leverage ratio, the Central Bank of Brazil considers that it should be integrated in Pillar I of the prudential regulatory framework. On the issue of "too big to fail", the Central Bank defends the view that a certain degree of state intervention is important in mergers in order to avoid that banks become too big to fail, thereby creating problems with respect to the fiscal stability of the State.

Accounting and auditing

On accounting, Brazil is in the process of converging towards IFRS. Many banks already apply IFRS on a voluntary basis. Public companies are expected to provide full reporting in IFRS as from 2010.

On auditing, Brazil is moving towards adopting International Standards on Auditing (ISAs); adoption is planned in 2010 for audits of listed companies. A general revision of the Brazilian surveillance system is currently taking place based on the US PCAOB model for inspections. This review will be decisive in granting Brazil equivalence under the 8th Company Law Directive which will enter into force next year.

Remuneration

The CVM is considering issuing recommendations on remuneration but, contrary to EU policy, they would not focus exclusively on banks. Due to reasons of security (risk of kidnappings), there are concerns regarding public disclosure of total remuneration.