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Speech by Commissioner Charlie McCreevy at the European Parliament ECON Committee

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At the EP Plenary meeting last week we had a first debate on the consequences for Europe of the US sub-prime mortgage crisis. I presented some preliminary reflections about the lessons that we possibly could draw. Let me start by summarising my key messages:

The European mortgage market is structured very differently from the US – so problems on a similar scale are less likely to arise in Europe. The sub-prime market in the EU is relatively small and rules on lending are stricter.

The recent turmoil has clearly demonstrated the interconnectivity and globalisation of financial markets. Risks have been spread widely. This is positive. Contagion, however, is an issue. This makes the Commission's regulatory dialogues with the US and with other jurisdictions even more critical.

Questions about mortgage lending in the US inevitably arises. While I support efforts to help people buy houses who would not normally have access to mortgages, it is clear there were very questionable practices used in how some of these mortgages were sold. Although we are better equipped dealing with mis-selling in Europe, we are looking at these issues within our ongoing work on mortgage credit and consumer education.

A key issue in the financial turmoil is the risk transfer via structured financial instruments. This is an issue that needs further attention. We need to look at the mechanisms at play in European banks, including the valuation of complex securitised products in times of stress.

As regards hedge funds, many have been particularly active in the structured credit markets. Many of those hedge funds – and their sophisticated private or institutional investors – may have incurred heavy losses in recent months. That is the way markets go. Financial markets function on risk. Many people demonise hedge funds. But you cannot put the blame for today's market problems on these funds. The crucial thing is that the EU prudential framework has so far prevented hedge fund failures from triggering wider systemic disruption. The current framework has been tested, and has held up well.

I also mentioned last week the role of Credit Rating Agencies in this crisis. They have been very slow in downgrading their credit ratings, their methodology has been weak and not very well explained. They also face a potential conflict of interest; on one hand Credit Rating Agencies provide objective ratings to investors of asset backed securities, on the other they provide advice to banks on how they should structure their lending to get the best rating. The role of credit rating agencies needs to be clearer. Because moreover, their ratings are used as a basis for the calculation of banks' regulatory capital. We need to know what rating agencies do and what they don't. I am following up these issues with CESR as well as with our international partners. What we need are clear, robust methodological rules and principles, rigorously applied.

Other market players also need to take their responsibilities seriously. And carry out due diligence. Were firms, and the professionals they employ, constantly assessing the quality of the instruments they were buying and selling? I hope that the Boards of all financial firms will examine their actions and draw firm conclusions. We believe that a "light touch", principle-based regulation is the best approach for the financial sector. But we need to remain vigilant and draw lessons. All parties need to take their responsibility – and take it seriously.

Finally, I would like to respond to the call for enhanced transparency, in a broad sense, which is so often heard in the debate. To improve our understanding of the mechanism at play in structured finance. To be able to better locate risks. To make certain that risks are well controlled.

I agree that we need enhanced transparency. But it is important to set out that the main prudential provisions in the new prudential framework on financial services, in particular Basel II, MiFiD and the draft Solvency II Directive, are not implemented yet.

Generally, financial institutions are still operating under the old regime. And the new, reformed framework is strongly targeted at improving disclosure, monitoring risk and enhancing the role of supervisors. Basel II also includes specific treatment for the transfer of risks between banks and off balance sheet Special Purpose Vehicles.

We should not delude ourselves into thinking that Basel II or MiFID would have prevented the present crisis. It is worth recalling that the crisis was born out of risky loans being repackaged and sold to institutional investors some of whom at least did not appear to fully understand the nature of the underlying risk.

Putting these assets in off balance sheet structures may have blinded many managers in financial institutions to the underlying risk inherent in these securities, particularly in a crisis. Did our supervisory authorities have, in their turn, a sufficient overview of the links, that a parent institution might still have, with an off balance sheet vehicle? How robust have the internal models used by risk managers been in the extreme liquidity crisis of recent weeks?

Given the apparent lack of confidence of banks to provide short term liquidity in the asset backed security area you can see that there are many unanswered questions. There is still some work to do to improve the oversight of these sophisticated instruments. A common theme ranging from Enron to Parmalat to today's crisis is the use of off balance sheet entities. We will need to address with supervisors the adequacy of risk appreciation and oversight of such vehicles.

We should be glad that the present financial supervisory framework has stood up to the strains of recent weeks. There will be lessons to be drawn from this experience which can only help improve the robustness of our supervisory system. I look forward to discussing these further with members of this Committee in the time ahead.

We all agree that a global world demands the highest quality accounting standards for use internationally. To ensure that accounting standards meet the demanding requirements laid down in the IAS Regulation, an endorsement process has been put in place.

The Commission values the excellent cooperation with the European Parliament in this process. Having attended your initial deliberations on IFRS 8 Operating Segments, it was clear that more input was needed in order to have a detailed discussion.

I am therefore pleased to present our "Analysis of Potential Effects" on the introduction of IFRS 8 in the EU. Our report is based on a wide-ranging consultation to which more than 200 organisations replied. It focuses on the issues discussed in ECON last April.

The report concludes that adoption of IFRS 8 would have positive cost-benefit effects. This is in line with the clear majority of answers to our consultations and with most views expressed in discussions with stakeholders. In particular, the report concludes that:

1. The use of the "management approach" in IFRS 8 has an overall positive effect on the quality of segment information, whose usefulness and relevance would increase.
2. The increased usefulness and relevance of segment information based on the management approach outweigh concerns expressed about the comparability of financial reports.
3. IFRS 8 appropriately addresses the global needs of users of financial statements' for geographical disclosures and, in practice, would not reduce this information by comparison with the "old standard" IAS 14.
4. IFRS 8 does not create problems relating to corporate governance in the EU.
5. IFRS 8 provides appropriate segment reporting rules for smaller listed companies. It is in the interest of smaller listed companies to provide the same information as larger companies as the information needs of investors are do not substantially differ according to company size.

We are encouraging further information on Corporate Social Responsibility in separate reports and we are supporting the development of guidelines for such disclosures.

A decision soon by the European Parliament on IFRS 8 would remove uncertainty about the treatment of segmental information in 2007 financial statements. Issuers are pressing us for an early indication of our intentions. An endorsement of IFRS 8 would furthermore support the EU's overarching objective of "IFRS as adopted in the EU" being recognised in all jurisdictions, including the US, without requirement for reconciliation.

We look forward to receiving the Parliament's comments on the report, and my Services are at your disposal should you need further assistance.