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Latest developments on policy response to financial turmoil

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Madam Chair, Honourable Members,

Ahead of the latest ECOFIN Council I would like to brief you on the latest developments related to the policy response to the financial turmoil, as well as the Lamfalussy review and the issue of supervisory convergence. I welcome the opportunity to hear your views on these issues before our discussions in Ljubljana on Friday and Saturday. I will also touch upon EU/US relations.

1. Policy response to the financial turmoil

During the past months, the nerves of financial markets have been put to the test. We have witnessed the rapid and dramatic collapse of the fifth largest US investment bank. The end of one of the best performing hedge funds in the UK in 2007. High volatility in the markets, especially in the banking sector. And dramatic liquidity moves from various central banks. The situation has deteriorated and pressure has increased in the markets.

The issues are known: weak internal valuation models, opaque securitization process, business models that were built upon disproportionate maturity mismatches between assets and liabilities, weak internal controls and poor disclosure standards, to name but a few.

During the last Spring Council, EU leaders concluded that while primary responsibility to deal with such issues remains with the private sector, authorities are to be prepared to take regulatory and supervisory actions where necessary. They also called for a prompt disclosure of all losses by banks and other financial institutions. I fully agree. Full disclosure is absolutely essential if we want to restore confidence and avoid a "drip effect".

In addition, EU leaders identified four key areas of work for the weeks and the months to come. These fully reflect the priorities set out in the Autumn 2007 roadmap:

First, enhancing transparency for investors, markets and regulators, in particular on exposures to structured products and off-balance sheet vehicles. Here, we have asked the industry to come forward with a credible, comprehensive proposal, answering the needs of regulators. So far the first signals are encouraging. By mid June, the industry should bring forward complete data on markets for structured products. Thereafter, this data should be updated and made available regularly.

Second, improving valuation standards, in particular for illiquid assets. This work is done at international level. It has recently intensified. We are happy to hear that the International Accounting Standards Board (IASB) will present a discussion paper including considerations on fair value measurement this month. In May, a task force of the International Organisation of Securities Commissions (IOSCO) will also present its findings. This is good news. We will continue to closely monitor progress.

There is a growing debate on whether fair value and mark to market measurements may have aggravated the crisis by bringing pro-cyclicality in financial statements. I want to make it clear that I believe that there are some real accounting issues and anomalies to examine, including the interface with the Capital Requirements Directive, such as the consolidation of special purpose entities or the measurement and information disclosed on risk exposures. Clearly, these and other issues –such as the impact of mark to market valuation when markets generally become illiquid and irrational- must be thoroughly analysed.

Third, improving the market's functioning and its incentives structure. Potential conflicts of interest, in particular in the case of credit rating agencies, are an issue. If the industry does not come up with satisfactory responses, we will consider regulatory alternatives. In particular, they need to strengthen the way potential conflicts of interest inherent in their business models are managed with oversight of the structured rating process by people who are free - and seen to be free – from any conflicts of interest by way of share options, appointment terms or otherwise. The Commission should be in a position to finalize its assessment before the summer break, once the final position of the industry is known, and once the assessments from the Committee of European Securities Regulators (CESR), the European Securities Markets Expert Group (ESME) and IOSCO are available.

Fourth, we need to reinforce the prudential framework and risk management in the banking sector through a targeted revision of certain aspects of the Capital Requirements Directive (CRD).

Proposals for changes to the CRD will include:

- new rules to limit the risk stemming from large exposures,
- a harmonisation of the definition of hybrid capital,
- capital requirements for default risk in the trading book,
- a definition of the significance of risk transfer,
- technical changes to the securitisation framework,
- a series of changes to ease the administrative burden.

The Commission is working closely with other stakeholders to ensure that a proposal is adopted by early autumn. I welcome the statement of the European Council two weeks ago in which it gives full backing to the project and underlines the importance of striving for an agreement between the Council, European Parliament and Commission by April 2009. A failure to do so would imply substantial, and from a market's perspective unacceptable, delays in waiting for the inception of the new Commission and Parliament.

I call on the European Parliament to make a similar statement; citizens need to understand that we can collectively make real progress on such important issues.

The implementation of the overall roadmap is progressing well, but recent events have added a greater sense of urgency to our work. In the months to come, it will be crucial to stick to the timetable and show that the EU is responding to the crisis effectively and in a coherent way.

2. The Lamfalussy roadmap and the issue of supervisory convergence

The turmoil has shown that we need to improve and strengthen the EU toolbox for the supervision of financial groups. It is also clear that much work is needed to ensure effective cross border crisis mechanisms and decision making. We need to build up an EU capacity for financial crisis prevention, management and resolution. The way forward was agreed at the end of last year and has been endorsed at the Spring Council. We should bear in mind that the cost of the banking crisis can be staggeringly high. Just look at past examples: around 8 per cent of GDP in Finland in the early 90s, almost as much in Sweden. So we need to advance.

The majority of the initiatives in this field need to be implemented during 2008 and require actions from the Commission, the Parliament, Member States and the Level 3 Committees. An important review of progress is planned for the upcoming informal ECOFIN meeting on 4 and 5 April. We want to hear your views and engage with you on all aspects of this work.

One of the most urgent tasks is to clarify and strengthen the role of the Level 3 Committees. We must clarify the responsibilities of the Level 3 Committees and that the Committees must be properly equipped to assume these.

The Commission has been exploring this issue thoroughly over the past months. We have presented our thoughts in a paper as preparation for this weekend's informal Council meeting. Copies have been presented to this committee. We believe four options can be envisaged. Let me briefly recall their essential elements:

- The first option would be to simply give the Level 3 Committees a set of minimum, general responsibilities in the area of supervisory cooperation and convergence. This would be achieved by aligning the Commission Decisions which created the Level 3 Committees.
- The second option would be to modify the Commission Decisions in order to include an indicative (i.e. non-exhaustive and flexible) list of activities that the Level 3 Committees should perform to foster greater supervisory cooperation and convergence.
- The third option would be to combine option 2, where necessary, with some targeted modifications to the relevant level 1 directives.
- Under the fourth option, the co-legislators would create European regulatory agencies, which would replace the Level 3 Committees. Under this scenario, these agencies could adopt individual technical decisions applicable to market participants.

These options should come as no surprise to you. They reflect the ongoing debate on the future of the Level 3 Committees. Neither is the fact that the Commission considers option 3 the most pragmatic way forward.

We believe that modification of the Decisions establishing the Level 3 Committees (to make them consistent and to give the L3 Committees more specific tasks to foster greater supervisory cooperation and convergence) and the amendment of the relevant directives provides the most practical solution for clarifying and strengthening the functioning of the Level 3 Committees without exceeding the December 2007 ECOFIN conclusions.

By contrast, seeking to transform the Level 3 Committees in a single or in separate agencies would be highly controversial and divisive. It would risk paralyzing the quick and practical progress that is so urgently needed. Furthermore, the real added value of this option remains to be demonstrated.

In addition to the clarification of the role of the Level 3 Committees, we believe that to improve and strengthen the EU toolbox for the supervision of financial groups, we need to come forward with bold, but also pragmatic proposals.

We hear some voices arguing that the European Union should respond to the current financial turbulence with more legislative actions and criticising the Commission for not assuming properly its right of initiative. I believe this impression is based on a false assumption.

- Recent events show that systemic risks are the most acute in the banking sector. This is why the changes we will table for the Capital Requirements Directive in early autumn will put colleges of supervisors on a firm legal footing. The objective will be to foster greater supervisory cooperation, with an emphasis on crisis prevention and the development of contingency plans.
- In the insurance sector, the Solvency II proposal is at a more advanced stage. Its adoption is expected by the end of 2008. It contains the necessary provisions to enhance the role of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). CEIOPS should for example play a large role in promoting supervisory convergence, and in the collection and publication of data. It would also have a mediation role between supervisory authorities in a group context in specific circumstances.

Adopting each of these proposals would already constitute substantial progress.

Further legislative measures may turn out to be necessary to address other current concerns. At this stage, however, we have to gather evidence and apply a bottom-up approach. There is major work ongoing to review supervisory and sanctioning powers, voluntary delegation of tasks, supervisory cooperation and exchange of information. The general contribution of the three Level 3 Committees to the preservation of financial stability will also have to be examined. We need more effective, more operational committees. We are reflecting on all options.

The current turmoil shows that early warning systems need to be strengthened. We agree that the international part of this work should be carried out by the IMF/FSF at global level. It is however also necessary to make parallel improvements to early warning arrangements within the EU, involving central banks, especially the 3L3 committees, ministries of finance and the Commission. A similar reflection should be carried out for crisis management.

I look forward to hearing your views on these issues.

3. EU-US regulatory dialogue

At the end of January, I was in the United States to discuss issues relating to the financial turmoil and other ongoing files with my US counterparts.

On the turmoil, one lesson of the subprime crisis is that inadequate regulation of mortgage selling and ratings in the US had a powerful contagion effect on the entire international financial system. The key lesson is that poor regulation in one part of the world can strongly reverberate on others. As a result, we need more regulatory and supervisory coordination and cooperation at international level, not less, and in many more financial sectors.

I welcome the fact that the recommendations of the President Working Group on Capital markets released two weeks ago are strikingly similar to the EU roadmap. I also note that work at international level is seen as a priority on many issues. This is a good signal. Our capital markets and our economies are inextricably linked, so we need to work together.

As you know, I support the idea of 'mutual recognition' in the field of securities. If we can get the conditions right, the rewards could be immense. This would also be a much needed show of confidence and would help to restore trust in the markets. So the substantial progress made in the recent months on the US side is a very positive development. I welcome in particular last week's public confirmation that the SEC will work with the Commission and CESR to develop a framework for mutual recognition. The coming months will be crucial. We will keep you fully informed of subsequent developments.

Thank you for your attention.