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The Financial Turmoil - The role of the EU-Commission

Check Against Delivery
~~Seul le texte prononcé fait foi~~
~~Es gilt das gesprochene Wort~~

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Good morning Ladies and Gentlemen,

Thank you for inviting me to discuss the financial turmoil and the role of the European Commission. Financial disturbances are no new phenomenon. In the 17th century irrational futures trading led the Dutch to believe that the value of a single tulip bulb equalled that of a luxury Amsterdam canal house… More recently we witnessed the dot-com bubble… And in this particular case, US subprime mortgages have been sold and traded under the false assumption that housing prices would continue to increase for ever…

Fools gold then. Fools gold now.

Lets face reality… Credit losses have grown well beyond our initial expectations and are certain to grow further. Nearly 40% of these losses can be traced back to EU banks. Liquidity strains in the interbank market persist… There are evident disequilibria: The securitization markets are all but closed. Commodity markets are booming. Fortunately exposures to credit risk in the insurance sector seem relatively low – despite the continued concerns regarding the fragility of US monoline insurers.

On the positive side, our fundamentals in Europe remain sound relatively speaking, compared to the US. We are less exposed to risks stemming from declining house prices. A recent publication by the Centre of European Policy Studies (CEPS) confirms that neither developments in the housing market nor the price of oil have the same impact in the EU as in the US…

But let's return to the financial turmoil and more specifically the EU policy response…

EU response: the ECOFIN Roadmap

On numerous occasions I have stressed that precipitous regulation is not the answer to the current situation, but that does not mean that it is open season for the "committee–tourists" of Europe to procrastinate endlessly, or for industry to drag their feet. It is almost a year since the turmoil began in earnest – the time for naval gazing is over. The time for concrete, effective responses has arrived. First, the industry has an obligation – a duty - to address the most acute problems. On risk management which in many cases was so woeful. On enhancing transparency, as this is elementary for the return of market confidence. And on incentive structures.

From a regulatory perspective there are no 'silver bullet' solutions. What we can do, however, is to try to strengthen market and institutional resilience going forward; precisely the aim of the ECOFIN Roadmap of October 2007, and try to ensure that incentives are properly targeted.

But we have to be realistic about what regulators and supervisors can achieve. And accept that now and then financial innovation may come at a cost. But compared to the past this risk can be better managed and reduced. Yes, we should do everything within our power to aim for prudential stability, while at the same time ensuring that markets remain innovative and open for new ideas. And supervisors also have to get more savvy – fully understand how markets function and better coordinate themselves. That means probably that we have to pay more to get appropriate skill sets in place.

The recent financial innovation - including the rise in off-balance sheet finance and the rapid growth of the originate-and-distribute model – has greatly increased the opaqueness of the financial markets. Many managers in financial institutions simply did not understand the products that their firms were designing, underwriting and trading. And nor evidently did many supervisors. Some smaller banks, whose traditional business model was bust, sought to generate higher returns by climbing the risk curve without understanding what they were doing. Several have gone belly up. Uncertainty grew about the way in which risks were being distributed across the system as well as the capability of markets to function under stress. In the end all actors were overtaken by the speed and severity of events.

This leads me to the first objective of the ECOFIN Roadmap: the urgent need for qualitative improvements in transparency for investors, markets and regulators. We have strongly pushed the industry to come forward with a convincing proposal, in particular on exposures to structured products and off-balance sheet vehicles. And basic data. A few facts and figures would be useful. This week the industry has indeed published its first quarterly report on primary markets. I very much welcome this, as better statistics will help the understanding of the market and its developments. This report has also been supplemented by data on holdings of securitised products, which will enhance the insight of regulators and policy makers into the exposures of financial institutions.

Efforts need to be stepped up with respect to bank disclosure practices. The industry is now starting a consultation on its guidelines for best practices on disclosures of securitisation activities and risk exposures. But while the G7 endorsed the FSF recommendation to apply full and prompt disclosure to the mid-2008 financial statements, these guidelines will not be effective until the year-end disclosures. For this reason we have asked the industry to clearly spell-out, how it will comply with the G7 request. This week the industry has provided me with a letter on their commitments to encourage the implementation of the FSF recommendation within the European banking community and to monitor the process to ensure consistency in the longer term. It will be very important to verify the effectiveness of these initiatives before drawing any conclusions. The delivery of this work is a critical test for industry self-regulation.

Upgrading valuation standards is the second objective of the Roadmap. There is a growing discussion on accounting issues, in particular with respect to the valuation of illiquid assets. The EU is part of a global approach to accounting standards-setting. This entails that the International Accounting Standards Board (IASB) is in the lead. It has recently accelerated its work. Concrete output is expected in the third quarter of 2008. Next to this, a roundtable of stakeholders will meet in September to provide the IASB with input on off-balance sheet items.

Let me stress that possible changes to the accounting standards should be assessed carefully and ought to be subject to proper consultation. Coordination with international partners is also elementary to ensure a level playing field.

There have been calls to temporarily disregard fair value accounting in order to neutralise possible pro-cyclical effects and avoid having to write-down assets. Intervention right now risks adding to the confusion and create even greater distrust in companies' accounts. What is needed is additional guidance on the valuation of complex and illiquid financial instruments. This has also been underscored in a report published by the Committee of European Banking Supervisors (CEBS) last month. It highlighted a number of accounting issues that may require further attention of accounting standards setters in order to improve consistency, comparability and transparency of valuation practices.

On disclosure issues, CEBS also published a report setting-out good practices with respect to banks' transparency on activities and products affected by the turmoil. These good practices, together with consistent enforcement of international accounting standard IFRS 7 as well as consistent transposition of the recent amendments to the Accounting Directives, are key to improve transparency for listed companies. I do agree however with those who say we must examine the interlinkages between accounting standards and capital requirements rules. We need to be sure that there are sufficient backstops and filters available so that prudential stability is underpinned to the maximum possible extent.

Our third objective is to strengthen the existing prudential framework and risk management in the financial sector. For that the Commission will soon come forward with proposals to revise the Capital Requirements Directive. The revision will in particular address elements of the prudential treatment of securitisation, as well as the large exposures regime and hybrid capital instruments. It will also take into account the work under way by the Basel Committee on Banking Supervision on banks' liquidity risk management which is due to be issued in the autumn of 2008, and seek to dampen the originate to distribute model in a way that is proportionate and sensible.

We are working closely with all stakeholders to ensure adoption of these proposals before the end of the year.

Fourthly, there is the issue of market functioning and specifically the need to review the role and use of credit ratings. The fact is that CRAs significantly contributed to the market turmoil by greatly underestimating the credit risk of structured credit products. I requested the advice of the Committee of European Securities Regulators (CESR) and the European Securities Markets Expert Group (ESME) on the various aspects of CRAs' activity and their role in the financial markets. I want to thank both CESR and ESME for their valuable work even if I do not agree with ALL of their conclusions.

The IOSCO Code of Conduct to which the rating agencies signed up has not produced its desired effects. I am not persuaded that the appropriate response lies in strengthening the voluntary framework established by the IOSCO code. International convergence is desirable, but on many issues, Europe must take the lead.

While some of the additional steps that the main rating agencies have announced are welcome, they are insufficient. This is one of many reasons why I have concluded that a regulatory solution at European level is now necessary to deal with some of the core issues.

I intend to propose in October a registration and external oversight regime for rating agencies, whereby European regulators will supervise the policies and procedures followed by the CRAs. Reforms to the corporate and internal governance of rating agencies will form a part as well. I will also try to strengthen competition by encouraging entry into the market by new players. I also want to make it clear that I see no point in regulating to give supervisors more powers if they are not financed and equipped to recruit and develop more expertise – especially in the field of structured finance.

Financial supervisory structures

The seriousness of the current financial turmoil has brought a sense of urgency to the need for a thorough and candid reflection on how to strengthen EU supervisory arrangements for financial institutions.

Some call for a more integrated European oversight system. I agree we have to move forward – procyclically, realistically. To make decisive progress this year means implementing actions which enjoy broad support from the EU Institutions, Member States and the industry. The Commission is therefore of the opinion that better cooperation among national supervisory authorities and convergence of their practices is the starting point for progress in this field.

The Level 3 Committees already play a role in this respect, but we expect them to intensify their efforts. To this end, an indicative list of tasks which the Level 3 Committees are expected to carry out will be included this year in their constituting Decisions. We want the Level 3 Committees to get closely involved in streamlining reporting requirements. To ensure adequate information exchange between supervisors and efficient cross-sectoral cooperation with other Level 3 Committees. To provide sharp and focused risk analysis and early warning in the event of threats to stability. And to play a central role in coherent application of the rules, including mediation among supervisors.

In addition to the strengthening of the Level 3 Committees' role in convergence of supervisory rules and practices, we are firmly convinced that supervision of our cross-border financial groups must be considerably enhanced. Systemic risks are the most acute in the banking sector. This is why the changes to the Capital Requirements Directive that we will propose early autumn will require colleges of supervisors for all cross-border banking groups. The objectives are twofold.

First, we want more exchange of information, cooperation, and agreement on reporting and capital requirements to significantly enhance supervisory efficiency.

Second, any signs of stress will be detected more easily and earlier-on in a college environment. This will permit joint contingency plans and crisis assessments and reinforce our system of crisis prevention in Europe.

In addition, a new Memorandum of Understanding (MoU) between national central banks, supervisory authorities and Finance ministries has been agreed upon to facilitate co-ordinated actions in cross-border crises.

Conclusion

Ladies and gentlemen, the financial turmoil has prompted a reality check of the financial system, both globally and for Europe. The ECOFIN Roadmap remains relevant and valid.

An efficient early warning system, reinforced prudential rules and strengthened institutions to handle financial crisis are needed. Within the European Union, Member States need to continue to further reinforce cooperation, in normal as well as in crisis situations. As for business, they must immediately enhance transparency and address urgently any weaknesses to their risk management systems and corporate governance.

No one can guarantee that financial manias and crises are history but our job is to work hard – in the EU and internationally – to make our financial system more resilient for the future.

Thank you for your attention.