SPEECH/08/379

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Regulation & Supervision after the Credit Crunch

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

Public Affairs Ireland Conference

Dublin, 4 July 2008

Ladies and Gentlemen,

Thank you very much for inviting me to this conference on the financial turmoil and the future of financial services regulation. In 1962 Marshall McLuhan[1] argued that "the new electronic interdependence recreates the world in the image of a global village". Since then, world-wide links have increased dramatically. In financial services, we have seen a huge transformation and expansion of markets, driven by factors such as liberalisation, globalisation as well as IT developments. Cross-border capital flows have grown at an astonishing rate. Recently we have seen the development of very sophisticated financial instruments traded around the globe.

While these changes have brought about huge benefits, the growing complexity of financial markets poses new challenges, as has been underscored by the recent financial turmoil. Let's face reality… Credit losses have grown well beyond our initial expectations. About 40% of the losses to date can be traced back to EU banks. Of course, there is more to come.

EU response: the ECOFIN Roadmap

On numerous occasions I have stressed that precipitous, ill thought out regulation cannot be the answer to the current situation. But we have been deliberating now for a year and the time has come to move forward. The industry itself has an obligation – a duty - to address the most acute problems. To strengthen risk management which in some cases was so woeful. And to enhance transparency, as this is elementary for the return of market confidence. But let's be clear about one thing : If the industry needs to improve its act, regulators and supervisors need to do so too.

From a regulatory perspective there are no 'silver bullet' solutions. What we can do however is to strengthen market and institutional resilience going forward; That was and is the aim of the ECOFIN Roadmap of October agreed last year .

Financial innovation is desirable but does come at some cost. That's why 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 that we have to pay more to get the best people. And this must be done in a sensible and flexible way that does not result in undesirable or expensive knock-on-effects.

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 and complexity of the financial markets. It has also increased irresponsible behaviour on the part of market participants. Many managers in financial institutions simply did not understand the products that their firms were designing, underwriting and trading. Many distributors understood perfectly well but their primary goal was to get the products off their books by the following quarterly reporting date.

[1] Canadian author (1911 - 1980)

Some smaller banks, whose traditional business model was bust, sought to protect overall 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, and when the music stopped the "pass the parcel" distributors were caught with the baby in their arms. Hence the massive losses among some of the major investment banks in particular.

The first objective of the ECOFIN Roadmap is 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. The industry is now starting to publish its quarterly reports on primary markets. I very much welcome this, as better statistics will help understanding of the market and its developments. Data on price and spread changes will be updated by the industry on a monthly basis. New data reports on holdings of securitised products, should also enhance the insight of regulators and policy makers into the exposures of financial institutions.

The banking industry has now started a consultation on its guidelines for best practices on disclosures of securitisation activities and risk exposures. But while the G7 has 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 they have 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.

But let me make a few general points about transparency : There is no point in overloading either supervisors or investors with container-loads of information every 24 hours in deference to the goal of transparency. What matters is the use – if any - to which the information that arrives can and will be put, to be able to distinguish between what matters and what doesn't, between time bombs and trends. In that context to get value from increased transparency we need to ensure that our supervisory and regulatory system in Europe is adequately resourced with the relevant expertise and that information for market participants is both readily accessible and comprehensible.

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.

Let me stress that possible changes to the accounting standards should be assessed carefully and ought to be subject to proper consultation. As the risk of getting it wrong is substantial… 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. There is a risk that precipitate action now could add to the confusion and create even greater distrust in companies' accounts. What is needed, in the short-term at least, is additional guidance on the valuation of complex and illiquid financial instruments.

On disclosure issues, the Committee of European Banking Supervisors 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 agree with those who say we must examine the interlinkages between accounting standards and capital requirements rules.

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 its formal proposals to revise the Capital Requirements Directive. The revision will in particular address elements of the prudential treatment of securitisation and credit risk transfer, as well as the large exposures regime and hybrid capital instruments, and on Wednesday we placed some revised proposals on the risk transfer issue on our website for consultation. 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.

In relation to financial supervisory rules, 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 in the 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, we hope that 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. This MoU reflects the commitment of all EU authorities to deepen cooperation in concrete ways and facilitate coordinated actions in cross-border crisis situations that may affect a financial group, infrastructure or market.

There is the issue of the need to review the role and use of credit ratings. 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.

The IOSCO Code of Conduct to which the rating agencies signed up has not produced the desired effects. I am certainly not persuaded that the appropriate response lies in strengthening the voluntary framework established by the IOSCO code. International convergence is desirable if it can be achieved – but per se, this is not enough. And let me make it clear, I do not believe that Europe should be in the passenger seat on this issue. We need to drive things forward and set the pace.

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.

It is my intention 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. The European Securities Markets Expert Group stressed the importance not just of governance of rating agencies, but also the importance of having an appropriate corporate culture as well.

In the proposals I will bring forward on credit rating agencies, I also want to ensure that supervisors who will have responsibility for oversight will have at their disposal sufficient resources and expertise to keep up with financial innovation and to challenge the CRAs in the right areas, on the right issues, at the right time.

Conclusion

Ladies and gentlemen, the financial turmoil has prompted a reality check of the financial system. It has also emphasized the growing world-wide economic and financial interdependencies. In our efforts to strengthen the supervisory and regulatory framework we should therefore continue to adopt a global perspective. Regulation and supervision can no longer be considered 'domestic', but in taking a global perspective, Europe must take the lead and set an example.

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

But perhaps most important of all is the need to ensure that incentive structures are right:

Incentive structures for distributors to structure credit products in a way that is not just designed to get them off their books by the next quarterly reporting date. We must have provisions to ensure that financial institutions that distribute retain a meaningful net economic interest in the products they sell for the longer term.

We must have incentive structures too for bankers and others involved in taking risk in the credit markets that reward prudence through the ups and downs of credit cycles – incentive structures that ensure a focus not on the soundness of the risk asset until the next bonus day or the next share option exercise date but through the next economic downswing.

And we must have incentive structures for credit rating analysts that ensure that the variable element in their reward packages are based primarily on long term rating accuracy as confirmed by meaningful long term grade migration and default statistics, and NOT primarily on the growth in the revenue flows from the "issuer pays" revenue generation model.

At the end of the day it is human behaviour that determines financial market behaviour because it is humans that make the markets – and it is financial incentives that influence how humans behave and therefore determine *market* behaviour and outcomes.

So in conclusion, Ladies & Gentlemen, progress has been made in framing appropriate responses to the financial turmoil of the past year. And everyone from regulators to supervisors to the boards of financial institutions have a role to play in ensuring that those responses are effective, proportional, well-targeted, and will stand the test of time.

Thank you for your attention.