SPEECH/08/684

Charlie McCREEVY

European Commissioner for Internal Market and Services

Speech at Annual AEJ Christmas lunch

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

Association of European Journalists (AEJ)

Dublin, 8 December 2008

Good afternoon Ladies and Gentlemen:

It seems no time since I spoke to you for the first time as European Commissioner at the Annual AEJ Christmas lunch in 2004. Today I am here – probably for the last time - in my current capacity. I say "probably" not because I want to see a headline saying "McCreevy hints at a second term" but simply because there is, I understand, some possibility that the life of this Commission will be extended by a month or two in which case it could be a toss up as to whether it is me or my successor that addresses you here this time next year.

Time flies when you are having fun - and it flies even faster when you are tackling mayhem - a word I use having regard to the breadth, depth, and scale of the problems that now beset the world's financial markets with all the negative consequences for everyone that those problems present.

I cannot say with any confidence that we are through the worst. The world's capital markets are massively inter-twined and the transmission mechanisms are increasingly powerful, spreading like wildfire from country to country, bank to bank, company to company, and from government to taxpayer. That's why the world's financial problems are our financial problems and as the banking systems' financial losses intensify, businesses and individuals financial losses will intensify too. For some it will mean losses of jobs. For others it will mean cuts in pay. For many - as stock markets have now almost halved in value in the space of 15 months - it will mean substantially reduced pensions. Governments everywhere are now having to think the unthinkable and nothing – nothing – can be taken for granted.

Today I want to concentrate on the European response to the financial market crisis. But I will first say a few words about the situation in Ireland: People shouldn't kid themselves into thinking that past spending levels are sustainable. Diminishing tax inflows cannot be replaced with ever rising levels of public sector borrowing in order to sustain spending levels that are simply not sustainable indefinitely : Investor appetite for government debt is not limitless and the more we borrow the more the premium for new debt we will have to pay. We need to guard against this – otherwise we will be propelled into a downward spiral where rising borrowing costs have to be met by even deeper spending cuts: The reality is that over coming years the current levels of public spending will have to be pruned and pruned hard.

For the European Commission the issues are different. First we must ensure that to the extent that the rules of the Growth and Stability Pact are relaxed to cope with the unexpectedly severe nature of the global downturn, such relaxation should be strictly temporary. Once the upturn comes Member States will have to move progressively back into compliance within the deficit ceilings and debt levels that are prescribed in the Pact.

In my own area, our response must be primarily focused on the financial markets themselves – recognising that within Europe we need to substantially strengthen the prudential supervision of cross-border banking groups and substantially improve the regulatory capital framework and accounting rules within which the financial services industry operates. But perhaps more importantly we need to strengthen cooperation with the other capital markets around the world. We need to improve information exchange. We need to strengthen clearing house capabilities so that we enhance the transparency of where real risk resides. We need to enhance the framework within which risk is managed. And we need to develop strong infrastructures within which derivatives contracts will in future be settled. Just as important is the need to work towards a level playing field to ensure consistency between markets, and avoid competitive distortions.

There are ten things in my view that have become absolutely clear since this crisis has evolved.

First, incentives in financial institutions have been tilted too much to short term profits at the expense of long term shareholder value and overall financial stability.

Second, in most Member States supervisors have lacked the resources and expertise necessary to supervise financial institutions effectively.

Third, the capital requirements framework for banks has been too pro-cyclical, too complex, and too capable of being gamed to facilitate excessive balance sheet leverage in financial institutions.

Fourth, the relatively new International Accounting Standards – especially in terms of the rules on provisioning for bad debts and the valuation of assets- are commercially and prudentially flawed. They have had unintended and damaging consequences for banks operating in illiquid markets and for the markets themselves.

Fifth, value at risk models have been permitted for risk measurement purposes that are wholly inappropriate from a prudential perspective: That's because they are right 3640 days in the 3652 days that there are in a decade but , as we have seen, when they are wrong on the other 12 days we have no idea of how wrong they will or can be - with results that are now there for all to see: Bringing banks to the brink , then the entire global financial system with inter-banks markets gumming up, requiring massive injections of taxpayers funds and guarantees to keep the system afloat.

Sixth, the originate to distribute model in securitization is inappropriate. It has resulted in excesses in short term risk taking, carelessness in risk analysis, and encouraged excessive leverage both within and beyond the regulated sector which in turn pumped up asset bubbles.

Seventh, the issuer pay rating agency model is not fit for purpose and the trust placed in many credit ratings for the purposes of determining capital requirements has now been shown to be wholly misplaced: Last July the U.S. Securities and Exchange Commission found that leading credit rating agencies improperly managed conflicts of interest and violated internal procedures for the allocation of ratings. Against this background, I am flabbergasted at the naivety of anyone who thinks these same credit rating agencies should be trusted to abide by a non-legally enforceable voluntary code of conduct drawn up under palm trees – A code that has proven itself to be toothless, useless, and worthless time and time again. Fool me once shame on you, fool me twice shame on me.

Eighth, corporate governance of financial institutions has been inadequate: The respective roles of directors, managers and shareholders will have to be rethought. The crisis has shown that excessive power was often in the hands of managers who misused it. Bonuses were structured on the basis of revenues from risk assets today without any regard to the likely costs that would arise later in the form of bad debts arising from defaults on those same assets. A corporate governance reflection is necessary to strengthen the role of non-executive directors and shareholders and to prioritize long term shareholder value over short term bonus payments.

Ninth, the global financial architecture has been weak: We need a comprehensive approach to international reform, a strengthening of international regulatory standards, international cooperation between financial supervisors, multilateral macroeconomic surveillance and crisis prevention, and a beefing up of international crisis and resolution capacity. Both the Financial Stability Forum and the IMF must be strengthened and their effectiveness and legitimacy must be improved. As one of the biggest capital markets in the world the EU must take a leading role in these crucial international reforms.

As to monetary policy, it is now absolutely clear that the orientation of monetary and exchange rate policies favoured too loose monetary conditions for too long and their transmission across the globe. Going forward the degree of leverage of households and businesses needs to be more carefully analysed and must play a bigger role in the decision making processes of monetary authorities.

Already in Brussels I have moved to address several of these issues that come within my remit - including revisions to the capital requirements directive, the introduction of regulation of credit rating agencies, proposals to make the securitization model more robust and responsible, changes to aspects of the accounting rules, strengthened supervisory arrangements for cross border banking and insurance groups, and the establishment of a working group to develop an effective clearing house to facilitate safe and secure settlement and netting in the massive credit default swap market. For over a year we have been working with Member States to deliver the actions contained in a series of roadmaps – no fewer than 40 measures covering prudential risk management and supervision, crisis management and the strengthening of supervision and coordination.

I am sure that it will be clear from what I have said that my last year in Brussels is going to be busy both on the European Agenda for the reform of the capital markets and with the international financial market regulatory dialogues with the United States, China and Japan. But I hope that by this time next year we will have in place a framework for a much more robust global financial market architecture: An architecture that will instil confidence once again in the integrity and robustness of the world's financial system. This might all sound pretty remote to the man or woman in the street who has lost their job, is struggling with their mortgage or sees their pension under threat. But at the end of the day it is the world's financial markets that have a critical role to play in solving these problems. Because it is the efficient operation of those markets that will once again ensure the channelling of savings into the productive investment that is needed for the creation of more jobs, faster growth, higher living standards, better pensions and more sustainable prosperity for everyone. Getting it right must and will remain our top priority.

Thank you very much indeed.