Charlie McCREEVY

European Commissioner for Internal Market and Services

Financial Markets & Economic Recovery - Restoring Confidence and responding to public concerns



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Good morning Ladies and Gentlemen and thank you for inviting me to speak at this important conference focusing on whether or not we have drawn the right conclusions from the financial turmoil that has engulfed the global economy. It would indeed be a foolish person who, at this stage, would answer "yes" to that question because we are almost certainly only half way through the storm and any

firm conclusions on long term solutions must be tentative at this time.

I suspect we will never get anything near unanimity on what went wrong and how to put it right because people's perceptions and conclusions are invariably coloured by the role they played or didn't play in contributing to the current sorry mess. There are some issues on which there has been broad consensus: The scale of irresponsible origination and underwriting, lack of due diligence, toxic securitization, and wreckless credit ratings was far greater in the United States than anywhere else in the world. There is no doubt but that it was primarily this that triggered the global crisis on the scale that we are now seeing.

That said European banks bought into these toxic securities and in Europe there is now a broad consensus that our supervisory systems are not and have not been up to the mark or fit for purpose. Not fit for purpose at an EU institutional level. Not fit for purpose at a Member State level. With cross-border banking groups now accounting for 80 per cent of Europe's banking assets the absence of formal mechanisms for dealing with a situation where one of those banks gets into serious difficulties, for adequate exchange of information, or for burden sharing was and is an unacceptable gap in our regulatory and supervisory framework.

It must now be clear to everyone that there is a growing gap between the EU supervisory structure, which is primarily organised on a national basis, and market developments, where integration and internationalisation lead to complex interdependencies and growing spill-over effects.

The crisis has brought into sharp relief the weaknesses of the present arrangements, in particular, significant coordination problems and conflicts of interest between Member States. This is why the de Larosière Group has been asked to make recommendations to the Commission on how to strengthen European supervisory arrangements. The status quo is not an option. The existing Committees of Supervisors are clearly lacking teeth. Bold steps are needed but there are very different ideas on how to go about it. Indeed there is a good deal of hypocrisy and double-speak too: While Member State governments are pretty well unanimous that the issue needs to be addressed the fact is that any time over the past decade when proposals - however modest - have been put forward to address Member State governments must come to them the consensus breaks down. recognise and address the need to stand up to the vested interests of their home supervisors who resist ceding anything with an eye to protecting their own empires. However never again will the political climate be so favourable for making a meaningful step forward and never before has so much momentum been built up towards a search for meaningful progress in this area.

I look forward to the de Larosière Group bringing forward concrete proposals which will contribute to greater financial stability in Europe and help maximise protection for depositors, policy-holders and investors.

Our reaction to the de Larosière recommendations will be incorporated in a Communication which is foreseen for early March, in time for the Spring European Council.

On financial services, it is premature to fix a list of precise issues to be covered. We need to factor into our work as much as possible the work of the G-20 where many of the issues we are working on will be considered also.

But as you know, well before the de Larosière Group was established the Commission was busy on a number of fronts where we were convinced that action at a European level was essential: In some of these areas we will work to achieve global consistency but nobody should think that that means waiting for the slowest or least ambitious train driver to depart from the station.

The crisis has required substantial state intervention in financial institutions in many Member States and in this regard I don't think anyone could argue that the Commission was anything other than vigorous and efficient in applying EU law, notably on competition and state aids, but doing so in a way that was flexible and rapid - which was essential to maintain confidence in the banking system and prevent the crystallization of systemic risks.

We have also been active in co-ordinating Member States and working with the Presidency as well as proposing adjustments to EU law where necessary.

On this, the Commission has come forward with and is still working on a number of measures: Revisions to the Capital Requirements Directive, the Regulation of Credit Rating Agencies, revised deposit guarantee schemes, amendments to accounting rules, as well as initiatives on executive pay, credit derivatives, and accounting. We are also reviewing the existing regulatory framework surrounding hedge funds and private equity.

The proposal for amendments to the CRD was adopted on the 1st October by the Commission. The French Presidency has managed to reach a political agreement in the Council and the Czech Presidency is now working with the European Parliament which will ensure - I hope - that the final format is robust, and not amended to a point where it is riddled with loopholes and get out clauses, or rendered so complicated or multi-faceted via amendments such that the key measures and disciplines contained in the original proposal can be too easily gamed or circumvented. I must also point out, however, that the current proposed CRD amendments must and will be only the beginning of a far more comprehensive review of the entire Basel 2 Accord which clearly requires some fundamental The Commission services have been looking at the areas of weakness in the existing framework: It is now patently obvious that the shortcomings of that framework include the absence of any overall gearing cap on bank balance sheets, wholly inadequate and inappropriate risk weightings for AAA rated structured products, the stupidities of intellectually refined value at risk models, over-reliance on External Credit Rating assessments undertaken by agencies who are paid by the issuer, and the absurdities of some mark to market requirements when markets are totally illiquid.

Lets be clear: The fundamental flaw in the financial theory underlying value at risk models that justified unsustainable levels of leverage needs to be widely exposed. As I said before these models may well be right for 3651 days out of the 3652 days in a decade. But on the day they are wrong we have no idea how wrong they will be or with what devastating consequences. In fact value at risk models are a bit like turkeys: After 100 days of being nurtured by the farmer the turkey believes that the farmer has nothing but his best interests at heart. The next day the farmer wrings his neck.

It is, of course, the case that diversification among less than perfectly correlated assets should reduce the overall risk of a portfolio below the risk of the sum of its parts. But as is now clear for all to see that theory is only of relevance to individual portfolio positions. Extrapolating the benefits of diversification to highly integrated global capital markets and then embedding the supposed benefits in prudential regulation is, it seems to me, a composition based on a fallacy. While an individual might be able to lower the risk of a personal investment portfolio via diversification, it should be obvious that the global financial system as a whole cannot diversify out of itself. Nor can the dozen or so global banks which dominate that system. Yet they have been permitted by misguided regulation to aggressively exploit the extra leverage on the back of the supposed diversification benefits that their internal models justify: While the models they use may be academically and mathematically brilliant the empirical evidence now available demonstrates beyond doubt that in the real world we inhabit they are fundamentally flawed.

I mentioned leverage ratios as one of the issues that need to be looked at in a more comprehensive review of Basel 2: While a maximum overall leverage ratio is desirable, sub-set forms of leverage will also be required to prevent excessive embedded leverage within on or off balance sheet assets or derivatives so as to limit the scope to game the overall headline, transparent balance sheet cap.

Linked in to bank capital requirements also is the issue of accounting policies: If these are not soundly based there will clearly be consequences for the soundness of the assumed level of bank capital itself. That's why Member States voted unanimously on 15 October on changes proposed by the Commission to accounting regulation - including more guidance on fair value and more flexibility to reclassify financial instruments from the trading book to the banking book. Aside from this issue I am concerned about other pro-cyclical elements that impact on the bank capital requirement regime, and in particular the issue of dynamic provisioning which enabled banks under the old accounting rules to build bigger buffers in good times in anticipation of portfolio impairment which invariably rises materially in less benign economic circumstances. The notion that the creation of these buffers is a denial of shareholder rights is, in my view, utter nonsense.

Another matter linked in to the CRD regime is the operating framework that is in place for credit rating agencies. The regulation I have proposed for them - including the registration and governance requirements - should go some way towards taming the significant shortcomings of the issuer pays credit rating model. So should the due diligence requirements in the revised CRD proposal. But, to be frank, I believe it is very doubtful whether ratings by issuer-pay rating agencies should, in the longer term, be used at all for the purposes of determining risk weightings on rated securities or loans. This I hope will be an issue that will reviewed within the context of the G20 work.

But there is no doubt that there were many roots to the irresponsibility we saw in securities and banking markets over the past decade: Aside from excessively loose monetary policy, inadequate supervisory resources, fundamental weaknesses in the capital requirements regime, and malpractices at some top rating agencies, executive remuneration structures were misaligned with long term shareholder and prudential interests. My services are currently examining not only the issue of executives' remuneration but also remuneration structure. The 2004 Recommendation on directors' remuneration will be reviewed.

With regard to remuneration structures and incentives in the financial services industry, measures that focus on addressing perverse incentives (e.g. those that induce excessive risk taking) are being considered. These initiatives will be part of any future reform package for EU Financial Markets.

Aside from all of this we have asked the industry to come forward with a clear roadmap as to how the risks from credit derivatives can be mitigated (specifically by ensuring that credit default swaps are cleared through a central clearing counterparty). Given the inadequate industry response so far I am keeping open the option of legislating.

So you can see there is much ongoing work: You are aware of what we have already done on deposit guarantee schemes and aside from the other work that I have mentioned this morning there is the review of hedge funds and private equity.

On hedge funds we have launched a public consultation on certain key issues such as the impact of hedge fund activity on the stability of the financial system and the degree of transparency towards regulators, investors and counterparties. The results – along with the results of a separate assessment of the effectiveness of self-regulatory codes in the private equity industry - will be discussed at a high-level conference in Brussels in February. On the basis of the responses to this consultation, the Commission will prepare appropriate regulatory initiatives.

So it should be clear from this that our work is extensive and comprehensive both at a European and international level. In conclusion, Ladies and Gentlemen, let me say this: I fear that a system that *never* fails may be beyond reach but I hope that a system where the consequences of failure are far more limited are and will remain within reach. And it is that for which we must strive in the months and years ahead.