Benoît Coeré: The reform of financial regulation – priorities from a European Central Bank perspective

Dinner speech by Mr Benoît Coeré, Member of the Executive Board of the European Central Bank, to the Association for Financial Markets in Europe (AFME), Paris, 6 March 2012.

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1. Introduction

Ladies and Gentlemen,

I am very pleased to be with you here in my new capacity as a Board member of the ECB. In my remarks today I wish to focus on some regulatory initiatives which I regard as being instrumental to a stable, well-functioning financial sector.

At the peak of the financial crisis, the Group of Twenty (G20) committed to an unprecedented overhaul of the financial regulatory framework. As you may know, it assigned the Financial Stability Board (FSB) a central role in developing and overseeing the concrete regulatory initiatives as well as monitoring their implementation. Indeed, international coordination is vital when dealing today's complex and integrated financial system. Three and a half years after the collapse of Lehman Brothers in 2008, I can safely say that much has been done to improve the resilience of the financial system, drawing on the lessons learned during the crisis. Still, the overhaul of the regulatory and supervisory landscape is not complete: several pieces of the puzzle still have to be fitted in.

Of the various areas that have been addressed by the FSB, I would like to focus today on three main issues that I deem of special importance from the ECB's perspective. First, I will discuss the timely and consistent implementation of the new Basel III framework, both at international and EU level. Second, I will consider the ongoing work to address the "too big to fail" problem, particularly within the specific EU landscape. Third, I will address some key policy issues in the field of OTC derivatives, financial markets infrastructures and the review of the Markets in Financial Instruments Directive, taking into account their importance for the orderly working of financial market activities.

2. Timely and consistent implementation of Basel III

The new Basel III rules form the cornerstone of the new prudential regime for banks. In view of the G20's commitment, a timely and consistent cross-country implementation of the Basel standards as well as the subsequent enforcement of the new rules are clearly high-priority issues which will pose significant challenges for the authorities and the banking industry alike. I very much welcome in this regard the Basel Committee's decision to assess the implementation of Basel III in parallel across major jurisdictions, namely the EU, the US and Japan this year. This effort is instrumental for promoting an international level playing field.

In the EU, as we all know, the EU Commission published last year its proposal for a Capital Requirements Directive and the Capital Requirements Regulation, which together constitute the “CRD IV”, the purpose of which is to implement Basel III in the EU. The ECB, in accordance with its statutory task, provided its Opinion[1].

Let me first and foremost stress that we acknowledge the leading role of the Commission and welcome its commitment to a consistent transposition of the new capital and liquidity rules into European law. One very important topic is the introduction of a *single rulebook* in the EU. We consider such a rulebook as an important step towards establishing a single market for financial services and enhancing financial integration in Europe. One of the benefits of this rulebook would be a commonly agreed definition of regulatory capital. The consistent application of such a definition would make it easier to compare eligible capital instruments from bank to bank within the EU, thereby strengthening the confidence of market participants in the loss-absorbing capacity of banks’ capital and, more generally, in the resilience of the EU’s financial sector.

The ECB proposes in its Opinion the possibility for national authorities, within the framework of a single EU rulebook, to adopt – with specific safeguards – stricter requirements in their respective Member States for macro-prudential reasons. This is necessary because Member States need to address country-specific financial stability concerns stemming from different structural features of their domestic financial systems. It is key that the possibility for Member States to apply these stricter requirements should be framed within the single EU rulebook framework. To this end, specific safeguards should be put in place. First, definitions should remain intact; only quantitative ratios and limits can be tightened. Second, the European Systemic Risk Board could play a coordinating role in assessing financial stability concerns and possible unintended consequences and spillovers to other Member States. Furthermore, the European Banking Agency (EBA) and the ESRB should publish regular updates on their websites of measures adopted by Member States and the underlying reasons for stricter requirements. Third, where financial stability concerns that triggered the application of more stringent measures cease to exist, the quantitative ratios and limits should return to a harmonised level set by the regulation.

3. Towards a pan-European approach to the resolution of systemic financial institutions

The FSB has adopted a dual approach to deal with the so-called systemically important financial institutions (SIFIs), namely by targeting both tighter loss absorbency requirements as well as improving the resolution technology available to authorities. A milestone in this area is the international framework for *global* systemically important banks agreed by the FSB and the Basel Committee on Banking Supervision. The framework proposes a progressive capital surcharge, depending on a bank’s systemic importance. This surcharge system is necessary to provide banks with correct incentives to decrease over time their own systemic footprint.

Even more crucial, and much less advanced, is the resolution approach to the “too big to fail” problem. During the financial crisis, the failure of a large cross-border banking group was not a credible option. As a result, governments had to resort to massive taxpayer-sponsored bailouts, in some cases even the ring-fencing of banks’ assets within national jurisdictions. This was a clear sign of the lack of adequate resolution powers, which would have minimised disruption to the financial system as well as the burden on public budgets.

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[1] Opinion of the European Central Bank of 25 January 2012 on a proposal for a Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and a proposal for a Regulation on prudential requirements for credit institutions and investment firms at http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2011_5_f.pdf

This shortcoming was realised both globally and in the EU. Last November in Cannes, the G20 endorsed the FSB's new international standards called "Key Attributes of Effective Resolution Regimes for Financial Institutions". On the basis of this document, the European Commission is about to finalise its legislative proposals for an EU framework for bank recovery and resolution.

The consistent implementation of these Key Attributes at international level is clearly a priority for the near future. How will all this work in practice for large cross-border banks in the EU's Single Market? The Commission's proposals – which I fully support – will provide a common language for domestic authorities for recovery and resolution planning, set up a common toolbox of supervisory and resolution measures, and also establish some principles for cross-border cooperation. All this already looks like a huge step forward from the status quo, where national regimes are lacking the necessary resolution powers, and not harmonised with each other, either. Moreover, we should not forget that in the Single Market major banks operate in more than a dozen countries via branches and subsidiaries. When Fortis was broken up in 2008, only three countries were involved directly in its crisis management, but cooperation still proved to be difficult. That is why I strongly believe that the EU needs to make progress towards a truly integrated resolution regime that adequately mirrors the cross-border nature of its banking sector.

First, let me mention that bank levies have been already imposed in several EU countries. Although they are undeniably a burden on the financial sector, I believe collecting *ex ante* funds for resolution is ultimately beneficial for all parties, if the financial system becomes safer in the long run. But having purely national financing arrangements would again present the practical and political challenges of coordination and eventually sharing burdens among several countries. A superior option would be to collect levies directly at EU level. Should this prove politically unfeasible, we would still at least need to have rules on how the national financing arrangements should together contribute to the overall resolution costs. Pooling resources in a single pan-EU resolution fund would bring a number of positive elements into the resolution framework of cross-border banking crises: it would reduce the amount that would be subject to burden-sharing; it would increase risk diversification and additionally provide the right incentives for cooperation. In any case, precise and transparent procedures and balanced decision-making mechanisms relating to the activation and use of the funds will be necessary to make it acceptable for Member States.

Second, I also think that a pan-European financing arrangement is the pre-condition for an even more ambitious step forward, namely the establishment of a single European resolution authority. Why would we need such a body? We have already learnt from past experience that crisis management and resolution calls for incredibly quick decisions. This typically means taking over a bank on a weekend and opening it for customers on the Monday, for example in the form of a bridge bank. Considering all the legal and technical complexities of such a move in a cross-border context, the only efficient way to do this is to have a single authority taking the lead and relying on national resolution authorities as its agents.

Certainly, a lot needs to be done to set up an integrated European resolution regime like this. But it is not something for the distant future. Recent events have underscored the need to be more ambitious – now. During the recent financial and sovereign crisis in Europe, we have seen the pernicious interaction between weaknesses in the financial sector and fiscal imbalances. Many policy initiatives have been put in place to restore confidence in European banks, despite concerns over their sovereigns. Low short-term interest rates in the euro area should in the short term help to prevent a disorderly adjustment of balance sheets and support the profitability of financial institutions, but they may weaken the incentives for repairing balance sheets in the first place. A pan-European financing arrangement would be one of the most effective measures to break the link between the creditworthiness of banks and that of their sovereigns. Its establishment would also remove the need for *ad hoc* policy measures in response to crises, such as the one-off EU-wide capital exercise conducted by the EBA, which incorporated market valuations of sovereign exposures in times of stress. I am also convinced that such an integrated resolution framework is likely to be the most suitable for the industry as well, since it ensures a level playing field and that the relevant rules are consistent throughout the EU.

4. OTC derivatives, market infrastructures, and the MiFID review

Let me now briefly comment on something that could be considered the "plumbing" of the financial markets: namely, over-the-counter (OTC) derivatives and market infrastructure. The reform of OTC derivatives markets has been a key part of the work to enhance the financial system's resilience since the global financial crisis. Indeed, the limited development of financial market infrastructures, weaknesses in bilateral risk management and the lack of transparency regarding counterparty exposures in OTC derivatives markets contributed to the financial market turbulence, as the cases of Bear Stearns, Lehman Brothers and AIG have painfully demonstrated. These cases also illustrated the potential systemic repercussions of malfunctioning OTC derivatives markets, particularly in view of their large size and close linkages with the underlying cash markets.

To enhance the functioning of OTC derivatives markets, the G20 agreed that standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms and cleared through central counterparties by the end of 2012; in addition, OTC derivative contracts should be reported to trade repositories.

I see two particular priorities at the current juncture. First, I have the impression that international discussions in recent months have focused heavily on the implementation of the mandatory clearing obligation and paid much less attention to objectives in the fields of standardisation and trading. We should not forget that standardisation is a pre-condition for centralised clearing. Second, as the EU and the US are moving to finalise the technical details of their new legislative requirements for OTC derivatives, I believe that further efforts are necessary to ensure consistent requirements. To this end, it will be essential that both the final EU and US rules converge to fully reflect the substance of the updated principles for financial market infrastructures, which the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions will release next month.

Let me briefly touch on the further development of financial market infrastructures for OTC derivatives, focusing on the role of central clearing counterparties (CCPs) and trade repositories. The rationale for fostering the use of CCPs is that a CCP reduces systemic risk by acting as counterparty to every trade, applying multilateral netting, and particularly stringent risk management practices. In this way, potential contagion risks in the case of a default of a CCP clearing member are minimised both for the CCP itself and for the financial system more broadly. On the other hand, trade repositories play a critical role in providing centralised data record services for OTC derivatives transactions regardless of their degree of standardisation. This enables a comprehensive overview of open positions and the corresponding exposures arising from OTC derivatives transactions.

There is a longer-term trend towards global and offshore financial market infrastructures which is linked to the economies of scale inherent in network industries and intensified by the introduction of mandatory clearing for OTC derivatives. As a consequence, we are seeing a growing concentration of systemic risks in a limited number of global CCPs. Such risks have not yet been adequately addressed. In particular, cross-border oversight arrangements often do not exist or are insufficiently developed, which implies that foreign authorities do not have the appropriate information to assess possible risks to their jurisdictions and/or to take action to reduce them. Furthermore, procedures and loss-sharing in the case of the default or resolution of global/offshore CCPs have not yet been developed.

Let me also mention that, in parallel, an increasing number of jurisdictions are considering the potential adoption of location policies for CCPs predominantly using a non-domestic currency. I would like reaffirm that as a rule, the core infrastructures for the euro should be located in the euro area. When they are not located in the euro area, they should comply with the CPSS-IOSCO principles, and also with central bank-relevant policies so as to preserve the integrity of the currency. Moreover, they should be subject to effective oversight by euro area authorities. There can and should be no automatic granting of liquidity to offshore CCPs.

Let me finally say a word on the revision of the Markets in Financial Instruments Directive – the MiFID review. The ECB fully supports the European Commission's proposals, which mark an important step towards strengthening investor protection and creating a sounder and safer financial system in Europe. The EU regulatory framework needed a revamp to adequately take into account financial innovation and the latest technological developments, and to address the G20 commitments to tackle the less regulated and more opaque parts of the financial system. With regard to the specific measures that are being proposed, let me mention a number of key issues. First, the ECB welcomes the upgrade to the market structure framework, which will extend the scope to a new trading platform, i.e. the organised trading facility (OTF). Second, the ECB also fully supports the proposed extension of pre- and post-trade transparency requirements beyond equity instruments, to include structured products and derivatives. When properly calibrated, such measures would enhance price formation and support the evaluation of financial instruments. Third, the proposals to increase data consolidation are also crucial, both for investors and the authorities. They would ensure efficient comparison of prices and trades across venues and facilitate the monitoring of market abuse by the supervisory authorities. Finally, as regards the proposals to tackle the development of new trading strategies, such as algorithmic trading and high-frequency trading, the ECB supports these amendments insofar as they would enhance the efficient functioning and integrity of markets.

5. Conclusion

In my comments tonight, I have attempted to give a brief overview of some of the themes which I consider important for the creation of a stronger and more resilient financial sector.

International coordination has reached unprecedented levels thanks to the distinguished role played by the G20 and the FSB. European integration has made giant leaps since the Lamfalussy report of 2001 and the De Larosière report of 2009. But this is not enough.

The euro area is an Economic and Monetary Union, an "E-M-U". European governments have strengthened the governance framework through the Six-Pack and the Fiscal Compact. Their actions to address fiscal and economic imbalances are bearing fruit. They should further enhance their efforts to boost the Single Market. So the "E" stands for "Economic". The ECB has used conventional and non-conventional measures to support price stability. It is striving to restore the transmission channels of monetary policy and make sure that the impulse stemming from it is transmitted uniformly across the 17 economies of the euro area. So the "M" stands for "Monetary". But the letter "F" – for financial – is missing: to operate smoothly and to be more resilient to crises, the Economic and Monetary Union has to become a true *financial* union.

I thank you for your attention.