

Yves Mersch: AMCHAM – principles versus rules

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at a conference of ALFI and the American Chamber of Commerce (AMCHAM), Luxembourg, 14 June 2007.

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Ladies and gentleman,

I would like to thank ALFI and American Chamber of Commerce (AMCHAM) for inviting me to participate in this conference. I am sure that this conference will reveal interesting views on the topics regarding principles versus rules-based approach. We will surely return home with new insights and suggestions for further research and developments.

Through my own research, I observed, as underlined by one member of the US Securities and Exchange Commission, that there is confusion as to the difference between rules and principles. Principles are frequently defined as “accepted and professed rules of action or conduct”. This confusion about rules and principles leads me to approach this topic from different angles.

1. In my view, rules have the benefits of being precise and durable. Further, they are widely accepted and adhered to by the industry and they generally achieve the sought objectives. Finally a rule reflects the consensus of past situations and can only address circumstances known or anticipated by regulators at the time of implementation. Thus, rules become outdated as circumstances change.

While principles are characterized by less preciseness, they remain more durable and widely accepted. However, their implementation is weaker and thus leaves more room for judgment. The setting of principles may be more appropriate in a rapidly changing environment marked by financial innovation and growing cross-border financial activities. Indeed, principles leave an open window to adapt judgments in case of changing circumstances and thus, need less frequent changes which would spread out confusion. But we have to be conscious that principles ought to lead to rules just like a constitution needs laws to be effective. The constitution of the Soviet Union, which was considered as one of the most democratic, went unheeded due to the gap in practice between this constitution and laws.

2. Of course, there are differences between private and public rules, only the latter benefiting from the monopoly of forceful implementation. Principles may also have private or public sources. Therefore the question of rules versus principles is often addressed through the criteria of the degree of cooperation or responsibility of the private sector. But additional criteria can be added such as the implication of the private sector in the elaboration and implementation of rules or principles. This conducts to reduce the potential conflicts and improve the identification of regulatory objectives, and the effectiveness of regulatory policy.

From this point of view, reinforcing cooperation between regulators and the industry actors, offers greater efficiency and flexibility than does the unilateral top down approach by which the regulator imposes the structure and details of rules to the industry. One recent example of a positive implication of the private sector was the response to regulatory concerns regarding the transparency issue on hedge funds. It seems that voluntary industry codes can facilitate market-based solutions and thereby relieve pressure on supervisory resources. Such an approach will be probably more appropriate to solve problems, particularly in the context of increasing market innovation.

3. Another way looking at the principles versus rules-based approach is the ultimate goal of the standards. Indeed, the means needed might vary from a strongly rules-based towards a soft-law approach. While if your ultimate goal is consumer or investor protection or market abuse, rules may be the right response. For other objectives such as avoidance of systemic risks and macroeconomic stability, it may be more appropriate for the regulator to favor

principles. In this context, the policy makers have to strike the right balance to reconcile the desirable clarity of rules with the idiosyncratic flexibility of the principles-based approach.

4. Yet another way to assess the rules versus principles debate is the scope of both standards i.e. what needs to be covered by rules and what can be left to principles. This scope can evolve over time. One of the main points in case is accounting. This topic has been raised after the collapses of some important players combined with other fraudulent accounting practices. These collapses lead some to question whether overly prescriptive regulation may conduct to perverse incentives, whereas others argue that the reasons reside in the lack of judgment on the level of the audit function, rather than in the non-compliance with rules.

Within the European Union, the impetus for accounting reforms stands mainly from the objective of creating a fully-fledged single market. The need to overcome differences in accounting standards between member states is a crucial step towards the integration of financial markets. In accordance with this process, the goal of the International Accounting Standards Board (IASB) is to develop harmonised accounting standards in order to increase comparability and transparency and facilitate better capital allocation. The IFRS/IAS standards issued by this Board, which is jointly financed by public and private resources, are expected to be endorsed by the European Commission. In this regard, these principle-based standards offer an adequate framework for cross-border convergence of accounting practices. However, their application on the national level may be completed with more specific rules in the course of time.

5. A last angle of view is what method is most conducive to cross-border activities. In recent years a wide range of financial innovations and a growing interdependence among financial institutions have drastically modified the international financial landscape. This will require an open and transparent discussion among the industry and regulators on the international level. In Europe, the Lamfalussy framework, based on the concept of comitology, fosters the important issue of cooperation among relevant authorities and actors.

The success of the Lamfalussy process in the securities field prompted EU authorities and member States to propose its extension to, inter alia, the field of banking regulation and supervision. This process should lead to a more flexible regulatory process and more consistent implementation of legislations and rules in member states. The success of current efforts to develop consistent cross-border banking supervision depends partly on an active and effective role of the industry actors. On the one hand, supervisory authorities have to deepen their understanding of the international dimensions of regulatory practices and make adjustments to national approaches in order to enhance supervisory convergence. A reinforced cooperation between national regulators is necessary in this process. On the other hand, suggestions and commitments of market participants regarding risk management principles are necessary for the soundness of the financial system.

Thus the CEBS (Committee of European Banking Supervisors) is conducting public consultation with relevant actors before submitting advice to the Commission or publishing standards, guidelines and recommendations. This work has significantly contributed to build the foundations of the EU supervisory convergence which should be able to promote further banking integration and maintain at the same time its effectiveness in pursuing financial stability in a more integrated financial system. Furthermore, the discussion held under the initiative of the Basel Committee on Banking Supervision has led to several important international agreements, which have been taken to improve capital adequacy, supervisory framework and market discipline. The implementation of these international standards should strengthen banks' capital worldwide and improve systemic stability. We in Europe, remain notably in favor of the multilateral approach. We would hope that international principles elaborated in international fora will also be timely implemented by all those involved in these agreements, unless a purely bilateral approach is considered superior.

6. To conclude, I would like to underline that effective rules and efficient principles, in my view, are both essential to promote financial integration and reinforce financial stability. It is delusory to think that principles applied on a standalone basis can eliminate the need for rules. Further, the rules-based system does not prevent the industry actors from the resort to interpretation and judgment. I believe that in a financial environment characterized by a fast innovation process, the regulator could grant sufficient time for the industry to develop robust practices and principles. If such principles turn out to be persistent and shared by all the actors of the industry, the regulator could adopt them as benchmark rules. However, in the absence of convergence of such market-based principles, the regulator might lay down guiding principles in order to provide incentives rather than imposing prescriptive and detailed rules

But at this stage we need to develop a strategic view on how progress can be made on a cross-border level to reconcile market actors' and regulators' objectives. As you know, full harmonisation would neither be feasible nor desirable in light of substantial differences in the legal settings even inside the European Union countries. However, a variety of regulatory instruments may be employed, ranging from fully market-based solutions to monitored self-regulation, principles-based public regulation and detailed legal rules. In order to identify the appropriate tools, the problem must be approached with due regard on the potential negative impact that regulatory and supervisory inefficiencies can have on global risk management and liquidity management practices as well as business structures. These issues need further consideration. Again further cooperation between supervisors, policy makers and industry actors is desirable for the task of defining legal standards. The success of such a process depends mainly on making the best possible effort to ensure consistency and reduce complexity in practice.

Thank you for your attention.