José Manuel González-Páramo: The regulatory and supervisory reform in Europe

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the presentation of the Report "Observatorio sobre la reforma de los mercados financieros 2009, realizado por la Fundación de Estudios Financieros", Madrid, 22 January 2010.

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Introduction

Ladies and Gentlemen,[1]

I am very glad to participate this morning in the presentation of the latest "Observatorio" from the Fundación de Estudios Financieros (FEF).[2] This year's report is dedicated to the very important issue of the Reform of the European Financial Markets. The current financial crisis has revealed a number of deficiencies in the European and international regulatory framework, which need to be addressed in order to place our financial systems and economies on a more solid footing.

As a result, a number of initiatives have been undertaken in the relevant European and international fora. The number and breadth of these initiatives is impressive and very promising. The report from FEF provides a very comprehensive survey of all the current initiatives, identifying the various strands of work and summarising the main implications for the financial sector and markets. I congratulate the authors on this exhaustive report, which represents a very useful reference for whoever is interested in understanding the ongoing developments in the regulatory and supervisory field.

Of course, the reader may not necessarily agree with all conclusions of the report. In particular, the report identifies a major risk of over-regulation and instead stresses the virtues from industry self-regulation. I beg to disagree. In my view, the main risk right now is not to do too much, but rather that we do too little.

There is a serious risk that the gradual improvement of conditions in the financial markets and the banking industry may diminish the sense of urgency and necessity of implementing reforms identified as essential to prevent the occurrence of similar crises in the future. Albert Hirschman, the American economist, noted that in many of the debates that precede social and political reforms of historical magnitude, the proposed changes are typically met with three arguments: (1) that they would produce perverse effects, (2) that they would be ineffectual, and (3) that they would jeopardise previous achievements.[3] I am afraid that we are now increasingly hearing the same arguments in the context of the debate on financial reform.

The crisis which began in the summer of 2007 has developed over time into one of the most disruptive and costly crises for our economies and societies that the world has experienced in many decades. Therefore, both public authorities and the financial market participants have a collective responsibility to do whatever is needed to address weaknesses in the

1 I am very grateful to Katri Mikkonen for valuable inputs and to Fátima Pires, Fabio Recine and Panagiotis Strouzas for useful comments.

2 Fundación de Estudios Financieros (2009), Observatorio sobre la Reforma de los Mercados Financieros Europeos, Papeles de la Fundación N. 34.

3 Albert O. Hirschman (1991), *The Rethoric of Reaction: Perversity, Futility, Jeopardy*, Cambridge MA; Harvard University Press.

regulatory and supervisory framework in order to provide sounder foundations to our financial systems.

Let me now stress some of the areas in which substantial work has been achieved to design and implement reforms.

Three key areas of reform: credit rating agencies, hedge funds and compensation practices

As I mentioned earlier, substantive progress has been made in the regulatory and supervisory reform as a response to the financial crisis. A remarkable amount of technical work has been undertaken in a demanding timeframe. All relevant initiatives have been coordinated globally, and the European Union has been a frontrunner in a number key areas. Three areas in which much progress has been made are: *credit rating agencies, hedge funds and compensation practices*.

- As regards *credit rating agencies*, a new EU regulation subjecting such agencies to mandatory registration and oversight in order to increase transparency and reduce conflicts of interest in the rating process has already entered into force in December 2009.
- As for *hedge funds*, the European Commission has proposed a Directive on alternative investment fund managers. This proposal, which is currently under debate, provides that alternative investment fund managers be subject to authorisation and harmonised regulatory standards, including minimum capital as well as disclosure requirements.
- On *compensation practices*, the European Commission was among the first to incorporate in a Directive proposal the Principles developed by the Financial Stability Board (FSB) for sound compensation practices, with a projected implementation date of end-2010. In this context, the EU was leading the international agenda in developing further guidance to align compensation practices with long-term value creation and discourage excessive risk-taking in the short-term. To recall, the G20 leaders in Pittsburgh in September endorsed the FSB implementation standards that aim to defer bonus payments, disallow guaranteed bonuses, and introduce a claw-back clause.

Recent proposals on how to strengthen the prudential framework

In addition, agreement has been reached globally on a comprehensive set of measures to strengthen the prudential framework in response to the crisis. In the EU, the Commission's proposal for an amendment of the Capital Requirements Directive of July 2009 includes the internationally agreed stricter requirements for *trading book* and *re-securitisations*.

Moreover, the recently issued proposals of the *Basel Committee* aim at improving the quality, consistency and transparency of *capital* for credit institutions as well as developing a framework for *liquidity risk*. As a consequence, the quality of capital, especially the so called Tier-1 capital which is of utmost importance for loss-absorption on going concern and crisis situations, will significantly improve.

- The risk coverage of capital requirements will be further strengthened for the counterparty risk related to *derivatives, repos and securities financing activities*, and incentives will be increased to move OTC derivative exposures to central counterparties and exchanges.

- A *leverage ratio* will be introduced as a supplementary measure to the Basel II risk control framework to curb excessive balance sheet growth and to safeguard against model risk and measurement error.
- *Capital buffers and forward-looking provisioning* will be introduced to mitigate the inherent procyclical nature of financial activities.
- Finally, a *global minimum liquidity risk standard* for internationally active banks will be put in place, requiring banks to hold sufficient high-quality liquid assets to withstand financial stress.

These proposed measures have the support of the Group of Central Bank Governors and Heads of Supervision, who requested the Committee to deliver a fully calibrated and finalised package of reforms by the end of 2010. The Commission envisages the timely incorporation of the aforementioned upcoming regulatory changes in the EU framework.

Recent developments in European prudential framework

Finally, international cooperation has been strongly reinforced and supervisory colleges for large complex financial groups have been established. At EU level, the setting up and functioning of colleges is provided for in the EU regulatory framework and is well advanced.

Looking ahead, legislative proposals should fully reflect the ongoing work at international and EU level aiming at enhancing the resilience of the financial system and protect consumers and investors against the impact of excessive risk taking and irresponsible market practices. Main priorities include: *(1) finalising the reform of the prudential framework; (2) addressing the risks posed by systemically important institutions; and (3) setting a framework for macro-prudential supervision*.

- *First*, the *strengthened prudential framework* currently being developed needs to be properly and timely finalised. The agreed measures, when implemented, will address many of the shortcoming highlighted by the financial crisis, and will increase the ability of financial institutions to withstand shocks and thus the resilience of the financial system. In this context, let me highlight the importance of a thorough impact assessment, to be carried out in the course of this year, before the final calibration of the framework can be made. The exact timing of implementation has, equally, to be carefully considered, so that the economic and financial recovery will not be endangered. In this context, adequate transition and grandfathering arrangements should be ensured.
- *Second*, legislative reform also needs to address the *moral hazard stemming from systemically important financial institutions*. In a resilient financial system it cannot and should not be taken for granted that authorities will always come to the rescue. The focus of the ongoing work by the FSB in this regard is threefold:
    1. It seeks to ensure that financial institutions, whatever their size and interconnectedness, should not cause undue distress to the functioning of the financial system and to the economy as a whole, if and when mismanagement drive them to bankruptcy. Possible tools include introducing capital and liquidity surcharges, or constraining size or the range of activities, to reduce the externalities of systemically important institutions to the society.
    2. The *core financial infrastructures and markets* need to be strengthened, for example via the promotion of central counterparty clearing and revision of supervisory standards on financial market infrastructures.
    3. We also need to review *resolution regimes* and bankruptcy laws to ensure an orderly winding-down of systemic cross-border financial institutions. In this respect, the European Commission has already launched a public consultation

on measures for a new EU framework for crisis management in the banking sector, in which policy options as regards early intervention, bank resolution and harmonised insolvency procedures are considered. In addition, it will be relevant to enhance the framework for coordination among the relevant authorities for financial stability in case of crisis.

- The *third and final area* relates to *macro-prudential supervision*. One of the key lessons stemming from the financial crisis relates to the importance of understanding and assessing the degree of "interconnectedness" between market participants. In particular, the crisis demonstrated that the nature and magnitude of the systemic risk in the financial sector is related not only to the potential illiquidity or insolvency of large banks or other major regulated financial institutions, but it also depends on the close intertwining between financial institutions, markets and infrastructures. The financial stability framework needs to be able to identify and assess systemic risks corresponding to the degree of "interconnectedness" I just mentioned. In this context, macro-prudential oversight would focus on factors and risks that can affect the stability of the financial system as a whole and therefore would complement micro-prudential supervision, which looks at the stability of individual financial institutions.

Macroprudential supervision in the euro area: The European Systemic Risk Board

Macroprudential oversight will be the key task of the European Systemic Risk Board (ESRB), which is built on the proposals of the High Level Group chaired by Jacques de Larosière. The European Commission's legislative proposals for the establishment and functioning of the ESRB have received the support by the ECOFIN and the EU Council. The European Parliament is currently considering the proposals in its turn. Let me also mention that the ECB/Eurosystem expressed its stance in the opinion adopted on 26 October. 2009 It welcomed the broad agreement reached by ECOFIN on the draft legal texts regarding the establishment of the ESRB and the involvement of the ECB in supporting the ESRB. As stated in its Opinion, the ECB has decided that it stands ready to provide the analytical, statistical, administrative and logistical support to the ESRB, including the Secretariat of the ESRB.

What will be the activities of the ESRB and what is its value added? The ESRB will be expected to actively monitor the various sources of risk to financial stability in the EU – across countries and across financial sectors, and also taking into account global developments. As a result of this monitoring, the ESRB can identify the risks and analyse in-depth how they could impact the financial system. Stress-testing and other methodologies could assist the risk prioritisation exercise.

The value-added to be provided by the ESRB is to link, in particular, macro-economic conditions, structural developments, and key vulnerabilities of financial institutions. This will permit to identify system-wide risks for the benefit of regulatory and supervisory policies. The monitoring, assessment and collection of information on sources of risk to be conducted by the ESRB, at the level of the entire EU, is of the essence, given the advanced financial integration of the internal market. In addition, the risks for Europe stemming from global sources will also need to be considered, also in coordination with the IMF and the FSB.

The financial stability monitoring in the EU as a whole will provide significant analytical and informational challenges. A large part of the effectiveness of the ESRB will rely on the quality and solidity of the analysis and information underlying its financial stability assessments. It will be important to set-up efficient arrangements between the ESRB and the new European Supervisory Authorities for the mutual cooperation and exchange of information, as foreseen in the Commission's legislative proposals. This would allow avoiding multiple reporting from financial institutions.

In order to support the new European macro-prudential function, as decided by the Ecofin, the ECB will provide analytical, statistical, administrative and logistical support, also drawing on the technical advice of the 27 national central banks and supervisors of the Member States. Accordingly, we will optimise our present capabilities and infrastructure in the areas of financial stability monitoring, macro-economic analysis, and collection of statistical information, to the benefit of the ESRB. This aims at reaping the maximum synergies in terms of expertise, resources and infrastructures with the existing central bank activities in the EU. To this aim, preparatory work is already under way.

Let me now conclude by saying that although much has been achieved to improve the European regulatory and supervisory framework, a lot still remains to be done. This is no time for complacency. We still need to make further progress to create a supervisory and regulatory framework, both micro and macroprudential, in which a strong and competitive financial system can enjoy sustainable growth. Europe should play a leading role in these developments.

Thank you for your attention.