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# Crisis or no crisis – Lessons for financial markets and regulators

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Thursday 7 February 2008

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## **Charlie McCreevy:**

### **Introduction: Crisis or no crisis?**

The speed and severity of the turmoil that has swept through the financial markets since last summer have taken both market participants and regulators by surprise. Hopes that it might be short-lived have now given way to a realisation that significant problems still lie ahead. Global financial markets are facing a severe test. It will take time before all the effects – and in particular the full disclosure of exposures and losses – have worked their way through the system and stability has been restored. Deleveraging is complex!

And the problems have spilled into the real economy. The US economy was first to suffer. It is still too early to assess whether the effects of the fiscal and monetary stimulus packages will prevent the US economy from sliding into a recession. The EU economy will not escape from the impact of the financial crisis and the US slow-down. But the EU fundamentals appear to be better. The EU does not have major financial imbalances, nor does it seem to face the same depth of problems as the US in the housing and mortgage markets. So for the moment the EU economy seems to be quite resilient. Most economists are expecting a slow-down in European growth, but not a full blown recession.

This does not mean, of course, that Europe does not face any problems of its own, nor that the way out of this will be easy. We need to concentrate on identifying the weaknesses that have come to light and ensuring that they are addressed effectively. But reflecting carefully – not by irrational genuflect. The private sector has an important role to play – and must do so. They, after all, are responsible to a large degree for these difficulties. But legislators, supervisors and central banks must also play their part. The commitment at the European level to work together is strong. Early in October, European Union Finance Ministers jointly defined the key areas where work is now under way, in order to respond to the current crisis and to prevent similar problems in the future.

I will come back to this. Before, I would like to share some reflections about the challenges faced by the EU financial sector and how they relate to financial stability.

## **Structural changes in financial markets – financial stability challenges**

What lessons should we draw from the current financial turmoil? First, it is quasi certain that the next time round the underlying causes for a future financial crisis will be quite different from those which gave rise to the current one. So we need to take a step back and take a long term view. What the European Union needs is a framework that offers the right incentives for creating financial efficiency and stability in the years ahead. And a framework that allows us to speedily and effectively manage crises if they arise. A framework that enables us to cope with the following challenges:

### *1. First challenge: - Intensifying globalisation:*

Recent developments have clearly demonstrated how globalisation impacts financial stability: the fall-out from the US sub-prime crisis rippled rapidly to the EU market, channelled into the international capital markets through securitisation. If we ever doubted it, we got a clear demonstration of how easily financial shocks are transmitted. And how new changes in financial markets can happen. Since August, Sovereign Wealth funds have invested some \$69 billion in European and US financial companies. Views vary on whether these funds should be considered as rescuers or as a potential threat to financial stability.

My views are well known; whilst the transparency, governance and accountability of these funds could usefully be enhanced, they have provided an indispensable source of necessary liquidity. New investors. An economic opportunity more than a political threat. Whatever your view, the fact remains that the globalisation will continue to intensify. And that before many years sovereign wealth funds will exceed the world's global currency reserves. So what is the way forward? Certainly not protectionism, because we will all lose. What we need to do is to promote stability, and not just within European borders – but internationally. Convergence of prudential rules is necessary. And frankly speaking, in a globalized financial market we also need much better coordination of crisis prevention and management. In the EU. And with our major financial partners.

### *2. Second challenge - The progress of EU financial integration*

The Commission has taken great strides to take forward the European financial integration process. Financial integration is key to delivering competitiveness, efficiency and growth in Europe. But will integration also bring about financial stability? Not necessarily. Strong framework rules, closer

cooperation and in particular a readiness to share information and coordinate actions across borders are necessary complements.

3. *Third challenge - The increasing complexity of financial markets*

Financial innovation has increased the opaqueness of the financial market. Several CEO's of large financial institutions are on record for admitting that they did not understand many of the new products that their firms were producing, selling or buying. Regulators too have struggled. Frankly I doubt that many were up to speed. Regulators being too far behind the 'knowledge curve' is not satisfactory – and must not happen in the future.

Securitisation is the current focus of attention. Even if it benefits financial stability in that it spreads risks and increases the efficiency of the financial system, securitisation may also create uncertainty. When nobody knows – 'Which parties are exposed to the risk? How big are their exposures' – uncertainty gives rise to market volatility – as we have seen in recent months. Is it not surprising, indeed stupefying, that over six months into this crisis we still don't know the full extent of the problem. Such opaqueness has also prevented effective crisis management. More difficult for authorities to identify institutions in trouble. More difficult to ask them to take corrective measures before it is too late. We therefore must enhance transparency in the financial system.

**Work in progress – before the financial turmoil**

Even before the financial market turmoil, some of the challenges had been identified in the EU. And there has been progress in adjusting the EU financial services strategy accordingly.

- In terms of *global cooperation*, regulatory dialogues as well as regulatory cooperation in international fora, such as the Basel Committee, are long established and successful ways of working. The recent agreement on accounting equivalence between the EU and the US is just one example of effective inter-continental cooperation.

- As regards fostering regulatory cooperation and convergence, the level three Lamfalussy committees have developed into important contact points for Europe's supervisory authorities. Memoranda of Understanding have been concluded between EU financial supervisors and central banks across Europe to reinforce cooperation on crisis prevention, management and resolution. Frequent and more sophisticated crisis simulation exercises are being carried out to test the EU's responsiveness.
- And with regard to enhancing transparency, one of the pillars in the newly implemented capital requirements legislation is devoted to disclosure.

The Commission's role in promoting financial stability is an important one; it is our job to prepare and propose rules to strengthen the defence mechanisms of the EU financial system, whether that be through regulation, soft law or the promotion of industry-led initiatives. Working with the grain of the market. Working with our international partners.

### **The market participants' role for enhancing financial stability**

Let me now turn to the role of the private sector for financial stability, which I believe to be of key importance. The stability of the financial system depends on the quality of risk management standards and disclosure by thousands of firms. But, regrettably, in recent months it has been easy to find examples where such standards have been lax and inadequate:

- Take disclosure standards in the securities market. It is an issue that is at the heart of the present liquidity crisis. Uncertainty about the size and location of risks in the securities market; inadequate pricing and valuation. We must have appropriate data and disclosure that could help identify problems in the securitized market at an early stage. Then liquidity will return to the market. And monetary and supervisory authorities could get a better overview. Market participants should deliver it – and deliver it now!
- Take the Société Générale crisis. I do not think any regulation can shield a company completely from the activities of a rogue

trader. At the same time, it appears that the bank's management may have overlooked early warning signals. Again, rigorous risk management is at the heart of the problem.

- Another example of failing standards relates to the credit commitments of certain European banks towards Special Purpose Vehicles – entities that sometimes are heavily exposed to mortgage-backed securities. Banks built up risk exposures but without any corresponding capital buffer. How could this be defensible? And how could top management allow this to happen? Or regulators – with some small banks clearly over-exposed by any measure of risk.
- And now I turn to the responsibilities of credit rating agencies and professional investors. I am not saying that credit rating agencies alone were responsible for leading others into risky waters. It is the duty of every business to carry out due diligence, and a subscription to a credit rating report is certainly not an excuse. Lesson number one is for all market participants to remember what credit ratings are. They measure the probability of default but with no responsibility to validate data provided to them on asset pools and no legal duty of care or legal liability to those who use the ratings. Many forget that. Yet, since credit ratings are used by some banks for calculating capital, based on legislation, it is our duty as regulators to ensure that credit ratings rest on a solid foundation. And lately questions have emerged: Were rating agencies really sufficiently clear about the limitations of their ratings?

Why did it take such a long time before the securities were down-graded or even put on 'watch'? How might credit rating agencies strengthen governance to increase confidence in their management of their conflicts of interest? I have said this before: I do not think credit rating agencies can expect to emerge from this crisis without significant changes to the way they operate. So the burden is on them to come up with real improvements. Otherwise we shall have to do this for them.

The current financial turmoil has highlighted some important weaknesses in the financial system. It is time to enhance disclosure, review risk management and ensure that the top management gets the information it needs to navigate safely and successfully, even when the wind blows. If the industry wants to

avoid a regulatory backlash, it must show itself capable of stepping up to the mark. Not with a grudging de minimis approach – but with real leadership and commitment.

### **The role of European policy makers**

So let me now return to policy makers. What can regulators and other policy makers do to promote a stable financial system?

In the short run, let me be clear: the scope for direct action to resolve the current crisis is limited. Central banks have been effective in managing the liquidity strains that have characterised the international financial system since August 2007. Efforts aimed at improving market transparency: fully disclosing exposures and losses should go some way to restoring confidence and calming volatility. But there are limits to what regulators can achieve – ultimately the market needs time to correct itself.

I believe the role of policy makers and regulators needs to be long term and forward looking. The ECOFIN recognised this back in October when it agreed on the list of actions that needed to be undertaken. I will briefly recall some of the main areas of work:

- Improving valuation standards of complex financial instruments is particularly important given the extended and significant use of mark-to-market and mark-to-model valuation methods. In particular, we need to find a better way of valuing financial assets when market liquidity is failing. Discussions are underway both within the EU, with market participants, as well as in international accounting and audit fora;
- We need to tighten prudential rules and enhance risk management. The full implementation of Basel II rules since this January should introduce more risk-sensitive rules and more comprehensive provisions on disclosure. But work still remains to be done in other areas, for example on liquidity risk management, concentration risk and securitisation. We will therefore come forward with amendments to the Capital Requirement Directive in the autumn. We should also look at whether colleges of supervisors could upgrade our crisis prevention framework.

- Finally we are looking at how to improve market functioning. Issues that we will look at include: How can we ensure that professional market participants exercise due diligence? What is the implication of the 'originate and distribute model' of banks for the credit markets? And of course credit rating agencies, as I mentioned earlier.

## Conclusions

It is time to conclude. The financial turmoil has prompted a reality check of the financial system, both globally and for Europe. It has confirmed that the direction of EU policy to deal with increasing market integration is right. But that we need to complete the job and carry out, continuously, health checks.

On the global scene, we should work together to find common solutions. An efficient early warning system, common prudential rules among major international parties and strengthened institutions to handle financial crisis are urgently needed. Within the European Union, Member States need to continue to further reinforce cooperation, in normal as well as in crisis situations. As for business, they must immediately check their risk management systems and corporate governance and address any weaknesses.

I have the sense that things will not be quite the same again. The Wild West of financial exuberance until the music stopped is over. New actors – sovereign wealth funds – have entered the stage. It is incumbent on all leading policy makers and business the world over to work together to minimize financial risk in the future. Anything less would be totally irresponsible.

Thank you very much.