

TOWARDS BASEL III? "REGULATING THE BANKING SECTOR AFTER THE CRISIS"

SPEAKING NOTE

- Let me start by saying that it is a great pleasure to participate again in this high level forum with such distinguished panellists and discussants. The issues discussed today are of great importance for the future of our EU internal market for financial services and will occupy a large part of our reform agenda in the next Commission.
- In my intervention today, I would like to focus on two main areas. First, on the prudential requirements for the banking sector, in particular on the various issues related to capital requirements. And second, I would like to discuss the future supervisory framework and the need to improve our framework of coordination for crisis management.
- So, let me first turn to the capital requirement regulation. The last stages of this crisis have revealed important solvency problems which threatened the stability of the financial system. As a result, a consensus has emerged

regarding the need to strengthen the solvency of our financial institutions by increasing capital requirements. Our banks were clearly not resilient enough to absorb a shock of this magnitude and they have underestimated the risks of a global and integrated financial sector, which trades very complex and opaque financial instruments. Indeed, important progress must be achieved in order to diminish excessive leverage and assign an adequate level of capital for each risk.

- This analysis has also triggered a fundamental debate on the weaknesses and the basic principles underlying the philosophy of Basel II. The title of this conference points in a specific direction: "Towards Basel III" and hints at a need for a comprehensive overhaul of the prudential strategy for the banking system. While the principle of risk-sensitive approach to capital requirement should certainly not be abandoned; we should not go back to Basel I; there are adjustments needed regarding the pro-cyclical effects of the Basel II framework. In this respect, the proposals currently discussed by the Commission services on dynamic provisioning will have a great role to play.
- There are many more proposals to increase capital requirements. I would like to elaborate a bit more on one in

particular. A debate has emerged on the measures that should be imposed on systemically important financial institutions; "too big to fail" banks. The crisis has illustrated the relevance of this debate and the moral hazard implications of such measures should not be underestimated. It is a delicate issue also with regard to the competitiveness of EU firms. Defining the concept of "systemically important" is not straightforward and it relates to both the size of the institutions and the relative size of the country hosting these institutions. In addition, systemic risk is not only a matter of size but also a matter of interconnectedness. We must therefore reach a solution which does not discriminate between entities based on the size of a country. If not, we risk questioning the single market as well as the capacity to compete with large countries like the US.

- Finally, another aspect of the banks risk management and accordingly a possible avenue for regulation I would like to highlight is liquidity risk. We must not forget the events that originated this turmoil or if I may use a popular saying, we must not reach that point where you "can't see the forest for its trees". Originally, the financial crisis was a liquidity crisis. Initial liquidity tensions that spread through the financial system gave way to more important solvency

problems and led us to where we are now. In some cases, failures could have been avoided simply with a different funding structure. Consequently, it is of the utmost importance to address liquidity risk adequately and efficiently in order to prevent future crisis. The Basel Committee's intention is to develop two quantitative minimum standards: (i) a liquidity coverage ratio that compares a credit institution's short-term liquidity; and (ii) a structural liquidity ratio that addresses funding reliability concerns over a long-term horizon (such as one year). Some Member States such as the UK have already announced their intention to introduce similar measures. Hence, there is a need to move forward in this direction and adopt consistent solutions to address this risk from an integrated EU perspective.

- These are challenging times. We have the responsibility of sowing the seeds of future financial stability by designing the appropriate banking regulation without undermining the fragile economic recovery that we are observing. Increasing the soundness of the financial system entails inevitably imposing a higher burden on market participants. In turn, there is a risk that this may slow the pace of economy by reducing the amount of credit in the short term. Nevertheless, I am convinced that in the long

run, higher financial stability will translate into stronger and more sustainable economic growth.

- After having talked widely about regulation I now want to turn to the second part of my intervention and draw your attention on the importance of supervision. Several months ago, in this same forum, I spelt out the aims of the plan developed by the De Larosière group. Today, I can proudly say that only a few months later the Commission has been able to develop its proposal to create a new European supervisory structure following the recommendations of the report. At the top of this structure, the European Systemic Risk Board shall be responsible for developing an early warning mechanism that will ensure a timely reaction whenever global unbalances start to build up.
- We should not be tempted to think that our problems in this financial crisis stem only from loopholes in the existing regulation. The crisis has revealed not only gaps in the regulation but also flaws in the supervisory framework. Therefore, we must continue to build a sound supervisory culture on the basis of the Commission's proposals. This supervisory net should promote the best supervisory practices and provide for more coordinated actions.

- Crisis prevention and resolution must not be separated. Although we are redoubling our efforts to create a robust regulatory and supervisory framework that may help prevent future crisis, the European Union lacks an effective crisis management mechanism with clear binding rules to deal with a major crisis involving cross-border financial institutions. At the international level, the G20 recently also stressed the need for orderly procedures to address cross-border resolution of systemically important firms.
- If we cannot organise efficient arrangements for cross-border crisis management, those voices calling for major changes in the single market paradigm will grow louder. We will move back towards more segmented market structures, with negative implications for the freedom of establishment and the right to provide financial services across the Union. On October 20, the Commission will put forward a Communication reflecting on an EU framework for cross-border crisis management in the banking sector. It will, most probably, launch an impressive reform agenda, which is both technically and politically very challenging.
- One of these elements required for efficient cross-border financial crisis arrangements is burden sharing. This has

been a taboo in the debate on financial stability for a very long time. But, I suspect that the crisis has changed perspectives on this matter.

- The rationale for ex ante arrangements for burden sharing relates not only to crisis management. Such arrangements can also help in crisis prevention by creating an incentive-compatible framework for co-operation among supervisors. In particular, trust and confidence in cooperation arrangements need to be underpinned by the assurance that the costs resulting from a cross-border resolution can be fairly shared and borne between the various stakeholders.
- Member States should know whether they would, in principle, be required to contribute and how such burden sharing would be organised. These are the kind of questions that could and should be answered ex ante. Nobody is in favour of a complex and rigid burden sharing arrangement based on some kind of distribution formula agreed ex ante. This could never work. However, the discussion should be open on general principles and there is clearly a need for further work and progress on this issue.

- In this context, I should also recall that the massive amount of public support to banks during this crisis has inevitably generated an important problem of moral hazard. If we wish to counteract moral hazard and eventually, reduce the burden on tax payers in future crisis, we must allow banks to fail, whatever their size. This has to be made possible both from a political and from an economical point of view. A clear message must be sent to the market through the establishment of concrete rules or plans (the so called "living wills") for the orderly wind up of financial institutions.
- To conclude, we must not abandon the path towards higher risk sensitiveness initiated with Basel II but rather construct a more robust, more comprehensive and less pro-cyclical framework on the basis of the Basel II principles. This regulatory framework must be complemented with clear crisis management rules and with an adequate supervisory structure. In this process it is crucial to strike the correct balance between financial stability, level playing field and the broader objective of achieving sustainable economic growth.