Jean-Claude Trichet: The regulatory and supervisory reform in Europe

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Eurofi Financial Forum 2009, Gothenborg, 30 September 2009.

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Ladies and Gentlemen,

It is a pleasure to be here among you and to say a few words of introduction before this distinguished panel. The purpose of my intervention is to lay out the main issues for our discussion.

- 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. Let me mention three of them: *credit rating agencies, hedge funds and compensation practices*.
- On *credit rating agencies*, the EU has already adopted regulation that will subject credit rating agencies to mandatory registration and oversight, to increase transparency and reduce conflicts of interest in the rating process.
- With regard to *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 the Principles developed by the Financial Stability Board (FSB) for sound compensation practices. Moreover, the EU has been driving the international agenda in developing further implementation standards that will align compensation practices with long-term value creation, and discourage excessive risk-taking in the short-term. As a result, the G20 Summit in Pittsburgh calls on banks to defer bonus payments, disallow guaranteed bonuses, and introduce a claw-back clause.
- Overall, agreement has been reached globally on a comprehensive set of measures in response to the crisis. The capital framework has been strengthened by introducing stricter requirements for the treatment of securitisation exposures and off-balance sheet vehicles, as well as for credit risk in the trading book. Disclosure requirements have been improved, to reduce uncertainty about banks' overall exposures in these areas. Guidance has been published to address the shortcomings in banks' risk management practices. Finally, international cooperation has been very strongly reinforced and supervisory colleges for large complex financial groups have been established.

While a lot has been achieved, a lot remains to be done. This is no time for complacency. 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: *strengthening the prudential framework; addressing the risks posed by systemically important institutions; and setting a framework for macro-prudential supervision.*

- *First*, future regulatory reform will aim at improving the level and quality of capital for credit institutions as well as developing a framework for liquidity risk. 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. Capital buffers will be introduced to mitigate the inherent procyclical nature of financial activities. A leverage ratio will be introduced as a supplementary measure to the Basel II risk control framework curb excessive balance sheet growth. Finally, a harmonised treatment for liquidity risk is also upcoming, requiring banks to hold sufficient high-quality liquid assets to withstand financial stress. These 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.
- *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. 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.
- We also need to review resolution regimes and bankruptcy laws in light of recent experience to ensure an orderly winding-down of systemic cross-border financial institutions. In this respect the legislative work planned by the Commission is very important. The EU Commission will soon launch a public consultation on a new Communication in which policy options to set-up an EU banking resolution framework will be highlighted. 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 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 oversight will be the key task of the European Systemic Risk Board (ESRB), which is built on the proposals of the group chaired by Jacques de Larosière.
- 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 from national central banks and supervisors. 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.
- The next few years are crucial for building up a strong, competitive and less leveraged financial system which will be subject to proper regulation and supervision, both at micro and macroprudential level. Europe should play a leading role in these developments. The panel discussion could help identify the most pressing priorities.

Thank you for your attention.