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### **The Future of Regulation**

Reform Scotland's Spring Lecture

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Amanda [Harvie],

Ladies and Gentlemen,

It is a great pleasure for me to be here in Edinburgh, a beautiful city full of history and tradition. I am honoured to have been invited by Reform Scotland to deliver this spring lecture, and I congratulate Reform Scotland on its first anniversary. We need more independent think-tanks like this in Europe to feed ideas into our policy debates.

Scotland has been hard hit by the financial crisis. Like the country I know best, it has a financial sector which is very large in comparison to the size of its economy. Scotland's financial sector is also exceptionally open and hence exposed to worldwide developments.

### **Financial Services Regulation in a Crisis**

Today I shall speak about the challenges of regulating in the middle of a crisis. And as European Commissioner responsible for Financial Services, I shall talk about financial services regulation.

Some people think that the financial crisis has led to a knee-jerk reaction of over-regulation. It has been observed that the level of regulation tends to jump following a crisis. Then over the years of the ensuing good times, there is pressure for lightening the regulatory burden and cutting red tape, which usually happens just in time for the next crisis to strike. So the level of regulation follows an inverse cycle to the economic cycle, overshooting the optimal level just after each crisis and undershooting the optimum following the peak of the economic cycle.

Some of you may think that in the wake of the crisis regulation is being "Europeanised" too much, or even "internationalised" in the G20. That national Governments and Parliaments are losing their sovereignty as regards financial regulation.

Let me focus on this for a moment. Clearly, we need to get the balance of regulation right. Both as regards the detail and coverage. And as regards the level – national, EU or global.

Financial regulation serves two main purposes: Firstly the so-called prudential objective, that is to prevent crises both of individual financial institutions, like Northern Rock, and of the financial system as a whole, as happened last autumn. The second purpose of financial regulation is to protect investors, particularly retail investors. This is done by a series of rules which determine the way financial institutions conduct their business relations with their clients.

The right coverage and detail of regulation is the level which achieves those objectives best without stifling business and innovation.

But it is difficult to get that balance right. Even more so in times of crisis such as the present, where excessive or ill-thought regulation could have the effect of prolonging the downturn.

Let me make a few remarks about the risks I see for rule makers in the present time:

I have always said that Europe would not regulate itself out of this crisis. Indeed, one of the main dangers I see for policymakers is the risk of swinging the pendulum too far and falling prey to populist tendencies. There are strong indications that this is already happening and that some demands are politically driven and not an actual response to the shortcomings laid bare by the crisis.

In Europe we have been taking a series of measures to correct and address such shortcomings. Most of the measures respond to commitments made at the level of the G20 with our main international partners. We have been quite diligent in implementing such commitments. But we have to make sure others do too. I shall be very vigilant in the months ahead to make sure our main partners also implement the G20 agreements. We do not want to impose disproportionate burden on our industry and make them less able to compete globally while others just pay lip-service to such agreements.

I also sense a tendency to risk aversion in our society. This is echoed by some politicians. As a consequence, we have very strong undercurrents wanting to regulate risk out of the system. While it is unquestionable that small depositors and retail investors and their savings should be protected, I do not think the same goes for those whose business model is to take risks to a greater or lesser extent. Our society badly needs them to continue to take risks. Otherwise how are we going to emerge from this crisis? If we do not have a culture that supports entrepreneurs then we will not be able to create the growth and jobs necessary to move out of this recession. Markets may have bottomed out but our economies have still some way to go. If we end up making life difficult for doing business then we are condemning our economies to lack lustre growth and high levels of unemployment. Now some will call me again the "free market Taliban" for this, but there is no such thing as a risk-free society. Free market liberalism is under attack. But it is not dead, not least because no one has found a better alternative.

But that is not the end of the story. It does not mean that we should not introduce any reforms. All of us who have a political responsibility in the area of setting the rules in financial services remember the days when we looked into the abyss last autumn. We have done a lot of work both in the EU and in other places to try to

understand what brought our financial system into cardiac arrest. I think we are all much wiser today and have quite a clear picture of what went wrong. So yes, there were some shortcomings. And yes, we do need reforms. These reforms are essential to restore market confidence.

Let me give you some examples of what we have been doing in the last months as a follow-up to the crisis.

### **Global Standards**

The first lesson we have drawn from this crisis, is that we need to tackle certain issues at a global level. I believe there is a wide consensus now that we simply cannot have global integrated financial markets and a patchwork of national regulation and supervision. There is a clear mismatch between the activity of global players trading and doing business across the globe and supervisors and rule makers overseeing those players whose powers stop at their national borders.

Also, national-based regulatory standards are inefficient for global business players since they have to juggle with different and often contradictory sets of national regulations and a myriad of national supervisors who do not always agree with each other.

So we need global standards and much more co-operation among supervisors. As the crisis has shown rather painfully, it is not enough to have good regulation and supervision in Europe. We also need the rest of the world to be appropriately regulated. That's why I was very encouraged by the outcome of the G20.

### **Credit Rating Agencies**

In the EU we have also moved quickly to address the shortcomings and conflicts of interest related to Credit Rating Agencies. There is widespread agreement that rating agencies contributed in a significant way to the financial crisis giving excessively high ratings to dodgy products. And what is worse: They did so knowingly. But they did this because they were paid by the issuer of those products – a blatant conflict of interest. And everybody relied on their ratings because the financial products which they were rating were too complex for anybody without a PhD in mathematics to understand. The new rules were necessary in this field and I think they strike the right balance.

### **Capital Requirements for Banks**

We have also acted on capital requirements for banks. As we are painfully learning, it's not just a question of putting capital ratios up or down. Increasing capital requirements during a recession will worsen the credit crunch by reducing banks' ability to lend. The challenge is to have targeted requirements, which kick in when they are needed and do not worsen cyclical tendencies. That's why for example later this year we will introduce more capital requirements for complex products known as securitisations and for trading book activities, two areas where capital requirements have been lacking. We will also examine how to mitigate the pro-cyclicality of current banking regulations. Here again we need to watch the level playing field. Therefore

we work within the Basel committee on banking supervision, which aims to set global principles for banking regulation. Different regulatory requirements in different countries are an invitation to regulatory arbitrage.

## **Oversight and Supervision**

We are also trying to draw lessons regarding the oversight of financial institutions in the EU. The banking and insurance markets are increasingly integrated and are dominated by pan-European groups. Currently around 70% of EU banking assets is in the hands of some 40 banking groups with substantial cross-border activities. Financial regulation and supervision has got out of step with financial integration. What is the solution? Well, some extreme European integrationists would simply say we should have one EU supervisor for all EU financial institutions. But a moment's thought shows the impossibility of that. 99 percent of banks in the EU are purely domestic, operating only in their national markets. The EU level is too remote to supervise, say, regional savings banks. The solution towards which we are working our way is, as always with the EU, a complicated one.

What we are banking on is colleges of supervisors for cross-border institutions where all those who have a stake are represented. If colleges cannot reach an agreement, we are planning to boost the powers of the EU-level Committees. Such Committees will work closely with national supervisors.

A second element of the revised supervisory structure will be a European Systemic Risk Council (ESRC) which will monitor and assess the risks to the stability of the financial system as a whole. The lack of any body to monitor systemic risk was one of the factors contributing to the current crisis.

## **Hedge Funds and Private Equity**

We have also adopted a Directive on Alternative Investment Fund Managers by which we mean hedge funds, private equity funds and similar funds addressed to professionals. This is a highly politicised area but since both sides of the argument are unhappy, I think we might have struck the right balance with our proposals. We propose to exempt smaller fund managers from the obligations of the Directive. We do not want to unduly burden small firms such as venture capital and start-ups for which requirements would be disproportionate and not justified by any financial stability concerns. While hedge funds are not a cause of the current crisis it is generally accepted that they can pose risks to the financial system. Therefore, hedge fund managers will have to register in the EU and be subject to supervision and controls, including on their levels of leverage. We shall also make the EU-wide marketing of funds from third countries conditional on their effective regulation and supervision, including as regards their taxation. So we are not – as some ill informed or ill-intentioned people have said – opening our doors to funds from "tax heavens". Quite the contrary, we are raising the standards for the products which are allowed to be sold in the EU.

## **Executive Remuneration**

We have also adopted a Recommendation on executive pay in the financial sector. It is not our aim to intervene in debates on what level of remuneration is just or appropriate. What we want is to link pay and incentives to long-term performance and prevent excessive risk-taking behaviour. We will soon propose to legislate to allow supervisors to require capital add-ons in cases of imprudent pay and remuneration structures which encourage short-term risk-taking.

## **Conclusion**

I hope to have conveyed to you the message that we are dealing with the problems unveiled by the crisis in a sensible and rational way. That we are learning from this crisis and addressing shortcomings. That we are reforming our system where this is necessary. We are striving to put in place a framework which will allow our financial sector to perform efficiently, which will give regulators the necessary tools to supervise market actors, which is sufficiently robust to avert crises such as the one last autumn and which will offer investors in financial services the confidence they need and the protection they deserve.

There is one important element that we must not lose sight of. Namely while we improve our regulatory framework there is a growing urgency to address the fundamental problem of impaired assets on many banks balance sheets. Whether Governments decide to create bad banks, good banks, special vehicles or even nationalise them it is imperative that some solution is found to the non performing assets on banks balance sheet. Otherwise we are going to delay our economic recovery. We risk being saddled with a banking sector that is incapable of performing its role in the economy. Addressing this issue is for me the number one priority today.

I shall stop here and I look forward to your questions.

Thank you.