

## **Speech given by Sharon Bowles at the lead conference in Frankfurt at Eurofinance Week, 16th November 2010**

### **Regulation and Supervision – Reforms and Results**

Right now you could say that regulators and legislators have never had it so good. A simple mention of the word 'crisis' and everything seems to be justified, and at the same time politicians complain about banks in particular - that they think nothing has changed and it is business as usual.

Well, quite a lot has changed and problems that happen with everything changing at once is that it can be difficult to predict the interactions, and all too easy to lose sight of some of the fundamentals of existing legislation, which has not all been proved wrong.

In Europe we have been following the global G20 agenda which has largely coincided in time with the scheduled review of the legislation of the Financial Services Action Plan. The crisis has created risk aversion – and that is a subject that I will return to – and one consequence of this is that, at least in Europe, safety now ranks above efficiency. Efficiency is no longer a sufficient reason for doing or not doing something, the safety argument always has to be made. I have no problem with these as partners, but efficiency is still needed.

Part of the reason for the safety first approach is that everyone is interested in the crisis and this has driven the rhetoric of politicians in particular, but also others. There is no doubt some have seen it as an opportunity to connect with citizens and - in my opinion - have fallen into populism on some matters that are too serious for that to have taken centre stage.

Chronologically the EU's first crisis response was CRD2 and CRD3, which I would largely describe as plugging holes that we all knew existed in Basle 2. Aspects like the large exposure regime and trading book were unfinished business that in my opinion, along with a range of things in pillar 2 of Basle 2, would have gone a long way towards reducing the effect of the crisis.

Of course we went further, for example on securitisation, and some of you may recall I have stood here before indicating the dangers of disproportionate measures. Now we are indeed in the situation of trying to find measures to encourage and restore securitisation.

The next response was also an overdue measure, the AIFM directive, and it suffered all the more because it was overdue and then done in haste. The final outcome was a good result in the circumstances, but what I have learned from the episode is that we were not good enough within the EU at sharing best practice early enough. It's no secret that the French hated hedge funds because they had a bad experience with retail investors getting their fingers burnt: the UK on the other hand regulated hedge fund managers and had conduct of business rules which protected retail investors, so of course they saw things differently. In Germany there was a lot of concern over asset

stripping and hidden position building for takeovers: again the UK had already addressed this by lowering the shareholder disclosure thresholds and requiring reporting of contracts for difference.

We are now catching up on some best practice sharing and I gave a speech in Brussels, which as usual is on various websites, setting out a range of markets issues that CESR are recommending, or which may now come up in the MiFID review and other EU regulation, and which have already been tested in the London markets. These include transaction reporting, wider regulation of commodity derivative participants, position management, trade data publication, rules on sponsored access, inclusion in MiFID and PRIIPS of wider product ranges such as insurance, electronic and telephone recording requirements and greater post trade transparency.

And of course that leads on to the next major item of regulatory achievement which is the setting up of the European Supervisory Architecture which will be key in much of the new sectoral legislation.

The Parliament made a big difference to the outcome of the supervisory package. Our objective was to have strong authorities and we also put a high priority on ensuring joined up supervision between the authorities. Financial markets and institutions are complicated because they interact with one another and operate cross border. Not everything can be pigeon-holed as banking, securities or insurance and pensions. Each must be aware of the other for interactions and perverse effects and know when to hold off, when to copy and when not.

What I am particularly keen to highlight is that rules in markets will have a direct effect on the prudential side, on capital in banks and other institutions and also on sovereign debt, growth and deficits. Likewise prudential rules on quality of capital as well as quantity will have knock on effects. All this takes me on to consider some of the upcoming proposals and, as I mentioned earlier, risk aversion.

We have underway the consideration of EMIR and the role of Central Counterparties. Last week we saw that LCH, a CCP, raised its margin requirement on Irish sovereign debt, and quite rightly too for they must have margins that reflect risk. In some ways this had the same effect as a rating downgrade and the markets responded in a pro-cyclical way.

Now we have already witnessed Commission statements that condemned a Greek sovereign downgrade as inconvenient – and my repost that I did not want ratings that were ‘convenient’ be that for investment banks or central banks – so is a future target for political wrath and control the margining requirements of CCPs? I would say it is important not to have political interference but to address this through ensuring that margining models are robust and encompass a range of volatility prior to needing adjustment.

All margining – on CCPs and in bilateral collateralised trading – will probably have this pro-cyclical behaviour and will need to be watched but the effect in CCPs may well be more systemic. This should remind us that in regulation there is never a win-win position, we can not eliminate risk we can only aim for better management, and that is why understanding is paramount.

On the CCPs we should also consider the debate around liquidity and connection to central banks, and following on from that potentially location requirements. I have already pointed to some dangers of political interference in risk management and margining, and I fear the temptation for these will be greater if there is built in reliance on central banks. Surely when at every turn we are saying we want to protect taxpayers, we should do absolutely everything possible to make CCPs stand on their own two feet – and that includes through any crisis resolution that might become necessary. If anything here we have a parallel with banks, bank crisis resolution mechanisms, severance planes and so forth and we should really be wary of creating to big to fail or too propped up by the state to fail, CCPs. Frankly, I do not think that is the mandate that we have from the public.

I have mentioned Sovereign debt in the context of CCPs but there are many issues here. The crisis has shown us how markets and sovereign debt and deficits are interlinked and of course sovereign bonds are at the heart of capital requirements and we have some serious things to consider with regard to maintaining their liquidity, not escalating their cost on governments and the special situation of the Euro.

For example in the various current and future proposals on short selling, CDS and MiFID, how will transparency around derivatives, hedges and short selling on government bonds be treated? After issue it is quite usual for governments to take out interest rate swaps such as floating to fixed rate, or a currency swap. Due to the volume of a sovereign issue disclosure is not seriously feasible without affecting costs and potentially compromising liquidity, so I doubt that Member States will concede that in the legislative process. Care may need to be taken to ensure that the same negative effect on liquidity does not happen through requirements on banks for disclosures on the other end of those swaps.

Liquidity of sovereign bonds is also potentially threatened if the short selling and CDS arrangements make hedging impossible and reduces market appetite. We may be in the position that regulation forces banks to purchase somebody's sovereign bonds, but other buyers in the market can not be forced, and if they are absent then liquidity suffers with all that that implies.

Finally on sovereign bonds there is the matter of risk weighting. I know I have already scared many Member States and banks by drawing attention again to the fact that when there is a currency union such that printing money is not an option, the assumption of zero risk weighting for sovereign bonds is incorrect. ECON resolutions have already incorporated this – though it is clear more latterly that people had caught up with what I was saying and started to move against it. But there is no escaping that the zero risk weight played a role in the sovereign crisis by not allowing market discipline and has been contagious in other respects.

Now, the European Council decision on bail-in reinforces this view, effectively putting beyond reasonable doubt that there is in the future credit risk in the debts of Eurozone governments, and this has huge ramifications, not least putting a torpedo through the middle of all of the CRDs 1 to 4, I think in a much more up front and comprehensive way than I had been attempting to formulate, even if that was not actually recognised.

There are a lot more things that are going on in the reforms that are worthy of comment, and I have only had time for passing mentions.

Resolution mechanisms, which I mentioned in the context of CCPs are of course a key measure, and since the time of wrestling with group support on Solvency II it has been clear to me they are missing an element of the single market as well as necessary for solving too big to fail.

All of our regulation is aimed at reducing risk, but if we do it in such a risk averse way that it is impossible – via bans – or unaffordable – via cost – to take a different view from the majority, then we can not get the smoothing of cycles that is made possible by those who are prepared to take the opposite view from the herd. So we are at a definitive moment these next few months when the choices that are made might make our risk-averse world more rather than less pro-cyclical.