European Banking regulation and supervision : the test of financial crisis

Présentation liminaire prononcée par M. Jacques de Larosière
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Cette réunion, qu'il a présidée et qui regroupait un grand nombre de personnalités financières et bancaires européennes, a notamment traité des sujets de régulation, de surveillance et d'harmonisation réglementaire qui se posent aux grands groupes transfrontaliers de notre continent.

Before we all delve into the subject, I think it is appropriate to make a few introductory remarks.

I would, first, like to say that, in the present circumstances, there would be no point in commenting, in a sort of academic and abstract fashion, on the merits of different institutional settings to promote European financial integration. I must admit that some of the excellent papers prepared for this meeting might give the impression of being somewhat detached form the present realities of the credit markets turmoil.

But we must "call a spade a spade" and deal with the issues in the context of what has happened since last August.

1. <u>The crisis -which started in the US subprime mortgage market and spread out internationally- has been the result of a number of factors</u> which can be, in my view, summarized as follows :

a) <u>the abundance of global liquidity</u>, over the last years, has fostered low interest rates. In turn, low interest rates have enticed investors and financial institutions to look for higher yields through complex products whose risks were not fully understood. One can add that the outsourcing of internal due diligence to credit rating agencies contributed to weaken the risk assessment process. In an environment of excessive indebtedness and "easy money", one can understand that the defaults observed on the US subprime mortgage markets a few months ago have been the trigger of cascading downgrades and, consequently of a loss of confidence by investors and therefore of the liquidity crunch.

b) more fundamentally, <u>the shift, over the years, of the banking system from intermediation to an "originate and sell" model has been accompanied by significant deviations :</u>

Indeed, the process of securitization has encouraged some banks to become less vigilant on the quality of their loans and more interested in the quantity of credits to be bundled and sold on the markets at remunerative fees. Besides, the growing role of "non-banks" -that are generally not controlled, in spite of their high leverage, and not subject to capital requirements- has compounded the situation.

c) the spreading out of risks through securitization was seen as protecting the banking system from too much credit exposure. But what was overlooked was the liquidity risk stemming from the potential loss of confidence of investors in the environment just described.

In turn, the liquidity crunch triggered by investors has impacted the banking system : because the banks are "in the market" and rely on liquidity for their funding. And also because the funds, conduits or special off balance sheet vehicles they have sponsored often entail the potential activation of back up lines or, more generally, reverberate on the reputation of the banks involved in these entities.

The fact of the matter is that the situation is not getting better : losses and provisions are on the rise for many banks and the knowledge of the total financial risks involved and of where they lie is still scanty.

Furthermore, mark to market accounting techniques are of little help when markets evaporate.

2. Can we say that banking supervision had foreseen the building up of the crisis and prevented it ? The answer, obviously, is negative. In fact, we have observed in Europe two basic banking crises :

- some banks with a "special status" have been tempted to achieve high yields through vehicles and conduits whose risky assets -and the credit back-up lines involved- were of a magnitude well beyond what their capital base would have normally allowed;
- another case is that of a mortgage bank whose funding was dependant -to an inordinate extent- on very short term market funding and who, eventually, experienced a run.

In both cases, these institutions were extremely vulnerable to a liquidity crunch.

I don't wish to "redo history" with the benefit of hindsight or to point a finger at specific financial institutions or supervisors. But, we should recognize that there have been significant problems in the way things were allowed to evolve and that lessons must be drawn.

As a purely personal side-comment, I believe, more than ever, that Central Banks are the best placed to supervise banks : they know the markets and they know the banks, which gives them a crucial advantage.

3. But, more generally, how do these events influence our vision of the future of the European banking regulatory and supervisory system ?

Given the relatively limited "domestic" nature of the european mishaps I have just alluded to, things could be sorted out or "muddled through" in a national context.

But what would have happened had a severe problem affected a large cross-border financial institution ? Do we really think that our fragmented system of regulation and supervision would have worked efficiently ? My concern and my instinct are that the answer might have been negative.

That is why I believe –this is my personal view- that we should, without further delay, overhaul the present system and move -for the large cross-border institutions- towards an intelligent “lead supervisor” model which would involve a true collegial approach for host supervisors as well as a stronger and effective decision-making CEBS. CEBS should gradually evolve towards a “European system of banking supervisors”. This, I believe, is doable and urgent. It requires political will if we are to seriously deal with the prevention of future crises.

Regulation should also be adapted to the reality of a financial system whose vulnerability is mostly related to non-regulated markets. It should be improved in some respects (regulation of non-banks, more adequate capital requirements on off-balance sheet entities…), although I believe that most of the required improvements should be handled by the industry itself in the form of best practices.

I should add, on a more positive note, that the ECB has acted remarkably and swiftly to help restore a more stable and normal functioning of the market. But that should not detract us from improving supervision.