The EUROFI Financial Forum 2009

"What priorities for the incoming European authorities in the light of the financial crisis?"

Sessão: "What EU legislative agenda in the coming years taking into account lessons of the financial crisis?"

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Intervenção do Ministro de Estado e das Finanças

Fernando Teixeira dos Santos

- The current crisis has shown the need for intervention in three main areas

1. Macroeconomic Imbalances

- As mentioned by Carmen Reinhart and Kenneth Rogoff in their very recent book "This time is different: eight centuries of financial folly", if there is a common theme to the vast range of crises they consider in their book, it is that excessive debt accumulation, whether it be by government, banks, corporations or consumers, often poses greater systemic risks than it seems to do during a boom.

- The recent events related to the current crisis are contributing to reduce global imbalances. However, those imbalances are still large and we should avoid returning to a growth path without correcting them.

- In this context, the G20 agreement (September 2009) on a "Framework for Strong, Sustainable and Balanced Growth" is welcomed and should play an important role by ensuring that fiscal, monetary, trade, and structural policies are collectively consistent with more sustainable and balanced trajectories of growth. I also welcome the role given to the IMF in this process, which consists in developing a forward-looking analysis of whether policies pursued by each one of the G20 members are consistent with the aforementioned objectives.

- However, we should also take into account that the crisis and the measures that were adopted to combat its effects have aggravated an important domestic imbalance: unsustainable public debt. This new imbalance must be taken into serious consideration by itself, as well as in its interaction with the current macroeconomic imbalances.

- On one hand, governments' interventions in financial sector have a significant impact on public debt: an immediate one in the case of capital injections in banking sector and a lagged one for other measures like guarantees granted that may be called in the future.

- On the other hand, fiscal stimulus measures lead to primary balances deterioration, increasing borrowing requirements as well, with implications on debt dynamics.

- Higher public debt ratios, ceteris paribus, induce an increase in risk-premium of the sovereign debt and downwards rating revisions, which, in turn, implies higher interest rates. Thus, extending these measures beyond necessary may have adverse effects in the long run.

- This means that both types of anti-crisis measures must be withdrawn as recovery takes firm hold. However, reversing the unsustainable debt trend will require more than a timely withdraw of stimulus measures. According to projection exercises that add the effects of ageing population on public debt and productivity fiscal consolidation measures will probably not be sufficient to reverse these trends. Significant and sustained primary surplus would be needed, but such objectives are most probably not feasible. In other words, it will most likely not be enough to correct the numerator of the public debt ratio, we must improve the denominator as well.

- Therefore, I hope and expect that two related areas will be back in full force to the upcoming agenda of the Eurogroup and the Ecofin, as relevant features of the exit strategies: improvement in the quality of public finances, by increasing efficiency and effectiveness; and intensification of structural reforms, fostering potential output growth in line the long term objectives of the Lisbon Strategy.

2. Regulation and Supervision

2.1. More and Better Regulation and Supervision

- It is true that some measures to strengthen the supervisory and regulatory framework have already been adopted at the EU level (e.g., capital requirements, scope of regulation, liquidity risk, securitization, credit rating agencies and tax transparency of offshores).

- However, further measures to reinforce financial stability and increase the levels of consumer and investor confidence on financial system are still needed. As mentioned in the G20 Communiqué, "a sense of normalcy should not lead to complacency". In fact, economic and financial recovery cannot lead us to forget how we have entered into this global crisis.

- By itself, our roadmap for regulatory and supervisory reform would be enough to keep our hand full at the Ecofin in the coming months.

- I welcome the G20 agreement to set stronger capital standards as the core of the financial sector reform and the commitment to develop by end-2010 internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage.

- The G20 agreement on compensation practices also represents a positive step forward to avoid excessive risk taking. However, it is far from sufficient for financial stability and it should not divert our attention from more important measures that must be implemented.

- E.g., off-shores – we have reached very important results on improving tax transparency in non-cooperative jurisdictions. However, there is still a lot of work to be done in the prudential supervision area to avoid regulatory arbitrage. At the global level, the FSB, in cooperation with the IMF, should play a crucial role in strengthening adherence of all (and not only of the systemically relevant) jurisdictions to international prudential and supervisory standards. But

I insist that in the meanwhile the EU must take the lead and keep the pressure in this area and, if necessary, to move ahead with measures at European level. I am confident that in the current momentum the other will follow – financial stability is now a dearly valued asset. Even if it implies a short run higher cost to our financial institutions, at the end of the day, they will be stronger and, therefore, more competitive.

- Additionally, further work is still necessary (i) on hedge funds (taking into account the ongoing negotiations at the EU level), (ii) on retail financial services and on the promotion of effective consumer and investor protection and financial literacy; (iii) on supervision of OTC derivatives; (iv) on procyclicality (only to give some examples)

- Accounting standards: we should not give up from achieving a global solution, with a high level of cooperation between the IASB and the FASB. This is the only way to achieve a level playing field for EU and US financial institutions. The global solution should aim to attenuate the undue procyclical effects underlying the accounting standards and the fair value, in particular, without compromising the transparency of banks' financial situation, which is crucial to restore confidence in financial markets.

2.2. New Supervisory System

- I would like to welcome the Commission's package of draft legislation to strengthen the supervision of the financial sector in Europe

Macro-prudential supervision

- It is now widely accepted that the absence of an effective macro-prudential supervision has concurred to the spread of the current crisis. More precisely, regulators and supervisors focused almost exclusively on micro-prudential supervision of individual financial institutions – and, even at this level, they overlooked a significant fraction of the supervisory perimeter – and not sufficiently on the macro-prudential side and on the potential risk of financial system-wide distress.

- Even when macro-prudential risks were identified, there was no mechanism to ensure that the assessment of risk was translated into action.

- In this context and taking into account the mutually reinforcing dynamic interaction between the financial sector and the real economy, including during booms, when risk may be building up although risk perceptions may indicate the opposite, I fully support the EU initiative to improve macro-prudential supervision and an effective early warning mechanism.

- However, the identification of financial system wide risks by the European Systemic Risk Board won't be enough to ensure financial stability. One must also guarantee that risk warnings and recommendations, although not binding, will be translated into appropriate policy or regulatory action, in line with the (June) Econfin conclusions, which assign an important role to the Council in this respect.

Micro-Prudential Supervision

- I welcome the creation of the European System of Financial Supervisors, and the decision to leave day-to-day supervision of financial institutions at the national level and to give the colleges of supervisors a central role in the supervision of cross-border groups.

- The European Supervisory Authorities should play a crucial role on achieving a higher degree of harmonization and coherent application of rules for financial institutions in the EU, thus contributing to the setting up of a single rulebook in the EU, in line with single market goals.

- The single rulebook should comprise:

(i) level 1 and 2 EU legislation, in which all national options and discretions should be removed (national experts should not forget this objective, agreed by the EU Ministers of Finance, during the negotiations of the Commission's legislative proposals).

(ii) technical supervisory standards issued by the European Supervisory Authorities (ESAs), which should be binding and directly applicable across all Member States, definitely contributing to high common regulatory and supervisory standards.

- But the ESAs should play an important role not only on regulatory issues, but also on the supervision of significant cross-border financial institutions. In particular, I fully support the Ecofin conclusions (June 2009), according to which ESAs should have clear powers on (i) the adoption of binding decisions to solve disputes among national supervisors; (ii) the adoption of binding decisions for national supervisors which breach community law; (iii) the direct supervision of some pan-European entities as credit rating agencies and EU central counterparty clearing houses; (iv) ensuring a coordinated response in crisis situations.

- Finally, a proper interaction between micro- and macro-prudential supervision must be ensured, namely through effective and timely exchange of information between the two.

- Given the importance and size of the European Union and its leading position in many of the aforementioned matters, the argument that stronger, necessarily costly, supervisory and regulatory measures should not be pursued because of the incentives to counterproductive behaviour of financial institutions in face of the higher costs involved, should not stop us from proceeding. Practical examples are the offshore financial centres and the possibility of requiring EU institutions that operate in those centres to undertake intensified due diligence and disclosure and higher capital requirements for EU institutions' established in non-cooperative jurisdictions.

- Additionally, we can show our commitment with this broader reform on regulation and supervision by reinforcing measures at the national level alongside the work that is being done at the EU level. In Portugal, we have complemented the financial system rescue packages with more permanent measures: legislation on remunerations, favouring the adoption of practices in line with shareholders' interests and increasing transparency – and on off-shores, preventing Portuguese financial institutions from granting credit to entities located in non-cooperative jurisdictions; a credit Ombudsman (Provedor do Crédito) has been appointed to ensure the protection of the rights of any party involved in credit relations within the financial sector, and a Domestic Standing Group for Financial Stability (composed by the Ministry of Finance and the National Financial Supervisors) has been set up and will be a key institution in macro-prudential supervision at the national level.. Additionally, in the beginning of September, the Ministry of Finance has launched a public consultation on the Portuguese Supervisory Model proposing a twin-peaks approach based on two supervisory institutions: one n charge of prudential supervision, another supervising the conduct of business rules.

3. Crisis Management/Early Intervention Tools

- The work on regulation and supervision should go together with work on building a comprehensive cross-border framework for the prevention and management of financial crisis.

- Important work has already been done – I recall that we have put a lot of effort into it during our Presidency in 2007 (MoU signed in 2008). Now we should review the procedures developed at the time, in view of the lessons from the current crisis (unfortunately, there was no need to simulate a crisis exercise to test the effectiveness of those procedures…). This review will improve the efficiency of the MoU and adapt it to the new EU supervisory system, according to which, for example, ESAs will play an important role in crisis management.

- Note that this working plan on crisis prevention and management will also improve day-to-day mechanisms of cross-border cooperation and will increase the level of harmonization across Member States. That is, we will benefit even if we will never need to manage a crisis again!