

## C. Lajoie's speech to the European Parliamentary Financial Services Forum

Ladies and gentlemen,

I am very pleased and honored to be part of this lunch discussion on the CRD changes in presence of such distinguished audience.

You just have received the last of the amendments proposed by the Commission. I would like to focus my comments on one of them, which I consider fundamental and that I largely support: the supervision architecture. I will also tackle another one, quite disputable, the so called "skin in the game". Finally I will venture to share with you three remarks that are outside of the scope of the CRD review but that are nevertheless critical to address the financial stability.

### The Supervision architecture

My message will be quite simple. Today, I think it is important and urgent to fully draw the consequences of globalisation and current financial crisis on the organisation of European banks' supervision and their regulation.

The current revision of the Capital Adequacy Directive must answer such concerns. In that regard, the proposed amendments are truly going in the right direction even though they could be reinforced as far as the status of the CEBS. I should also mention that there is no spare time; decision must be made urgently.

On obvious grounds of markets' globalisation and efficiency, banks have organised themselves along large worldwide business lines, and rely on centralised support and control functions, such as Finance, Risks, Treasury, I.T. Systems... Operational structures do not fit anymore with legal structures. From a management point of view, the distinction between branches and subsidiaries now belongs to history. Therefore, risks are now appreciated at consolidated level.

Yet, supervision is still essentially focused on the legal entity and the country where the bank operates. This is a source of difficulties, even though some supervisors, for instance in the United States and France, have realized that the consolidated level is the one to consider. Local authorities' assessment of risks linked to activities carried out on their territories can only be incomplete, when not misleading. This supervision architecture is not efficient and creates administrative burdens for financial institutions.

It is indispensable that banking supervision, and more generally financial institutions' supervision, fits with their globalisation and hence is organised at consolidated level.

In the current context, the most effective solution is to set up colleges of national supervisors for international banks. The supervisor of the parent company would chair it and act in concurrence with his concerned colleagues. The host supervisors would transmit their expertise of national specificities and participate to the appreciation of the group's global soundness, which is the only guarantee of each of its components' resiliency. Decision making should aim at being consensual. When the consensus cannot be reached, the home supervisor would eventually arbitrate. This is already the rule in the Directive regarding Pillar 1 on internal models' validation. This should also be extended to Pillar 2 requirements, in order to close the debate on capital adequacy **at consolidated and solo level**, and more generally to all supervisory matters. Of course, a mediation scheme could be added to overcome persisting disagreements provided that this mechanism does delay the decision schedule. Certainly, such colleges should also be open to the main non-EU supervisors, as needed.

Such an organisation could however lead to diverging implementations of regulation given the pre-eminence of the home supervisor. A guardian of supervision's coherence is needed, at least within Europe. This should clearly be the CEBS' mission. Recently, this Committee

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has adopted the qualified-majority voting, a more efficient decision-making rule than consensus. CEBS must have the capacity to make decisions, which should be binding for all. We are close to this objective, provided that the "comply or explain" principle is strictly framed to truly legitimate grounds and fully disclosed. Capacity to make decisions also means a strengthened legal status, better defined and recognized missions and surely independent and adequate resources, both from a budget and staff point of view.

Participating to this two-level scheme, each supervisor would be in charge of safeguarding the financial stability, not only at national, but first and foremost at European level. Hence, it is important to introduce such mission in their mandate.

I shall acknowledge that the proposed revision of the Directive on own funds is quite in line with these principles and that I fully support the amendments written by the European Commission regarding the supervisory arrangements, even though I believe the proposal is somewhat short on the CEBS role and means. Europe must be unambiguous and ambitious; conservatism and wait and see attitude should be left aside. The depth of the current crisis justifies challenging national prerogatives when needed. A prevention system - through supervision - must be set up, which must be as efficient as possible.

### **The "skin in the game"**

Reminding investors that they are responsible for the risk they buy and requesting them to assess this risk cautiously is certainly highly commendable. This responsibility will lead them to be more demanding on the information given by the arrangers and the rating agencies. I have no objection to that. However the proposed provisions are much too prescriptive and may not be applicable in some cases. Moreover, the requirement for regulated investors to request from the arrangers to retain some part of the risks they take when buying structured instruments could clearly be interpreted as a way to alleviate their own responsibility. Not to mention that this provision may deter banks from arranging bespoke risk transfers or financing structures as they will not be willing to keep such specific risks in their books.

Should the European Authorities wish to introduce constraints beyond the already demanding best practices proposed by the Industry and, in some way incorporated in the Directive, we believe it would be more effective and more in line with the investors responsibility concept to request such investors to inquire about the retention feature but to let them free to assess the relevancy of the response for their investing decision.

### **Outside the CRD**

My last comments are not part of the CRD review per se but are touching very critical points for the financial stability.

#### **The capital buffer temptation**

On caution grounds, authorities seem tempted to tighten requirements on capital adequacy for own funds. Is this really wise? This may squeeze credit distribution or even worse, be an incentive to take more risks in order to get the return expected on these additional own funds. This temptation is clearly untimely adding to the pro-cyclical nature of Basel II.

#### **The accounting Standards**

Among other conditions, an in-depth review of accounting rules is indispensable. In particular, the crisis has highlighted the amplifying effects on cycles caused by a too wide and systematic application of the marked to market concept. This is true up and down the cycle. It is adding to the previous pro-cyclical effect that we found so detrimental in our previous comment.

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Two corrections should be considered by the IASB or, eventually by the Commission for time sake:

1. Opening more widely the marked to model technique in case of illiquid instruments; this is the direction taken by the US GAAPs and it is an appropriate measure when the trading intent remains valid.
2. Reclassifying non tradable instruments, the economic value of which is totally distorted and that the firm is willing to keep beyond the trading horizon, at book value in an asset category like loans and receivables, immune to market volatility but yet not to economic depreciation.

In this depressing phase, reviewing the rules may appear suspicious; however, this is also a key and urgent measure to take to stop the current vicious circle. Strict rules and disclosures may also protect the market from any abuse in relation with the proposed changes.

### **The supervision efficiency**

Banks showed weaknesses in their management; supervisors were not strong or articulated enough to stop them in due time. Supervision should look forward and not backwards, which means switching from an administrative and legalistic attitude to a more proactive and anticipating approach. This is probably a matter of mission statement, closer cooperation with Central Banks, but also of culture, expertise and finally resources. This cannot result from a Directive but I would encourage all the Authorities, including the European parliament to start working on this qualitative and organisational issue as soon as possible.

Ladies and gentlemen, I thank you for your attention.