

EPFSF Lunch Discussion

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“Financial Turmoil: Next steps in the EU”

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Ladies & gentlemen,

the German poet Hölderlin famously said: “Where danger is, salvation also grows”.

Well, Hölderlin gets right to the heart of things here – also with regard to the financial crisis. I am curious to learn today how valid you think this optimistic stance is in the current circumstances.

I must say I am not terribly optimistic. Why is that so?

Let’s just take a brief look at the situation of banks. After the collapse of Lehmann Brothers there is no easy way back to normality. Measures to “stop the bleeding” are consequently the centrepiece of all political and market activities.

Since then banks have focused on

- reducing exposure to risky assets,
- securing more stable funding and
- increasing capital.

Nevertheless, many banks’ CDS spreads remain close to the peak of 2008. This suggests a market perception that risk reduction still has some way to go.

At the same time banks face difficult market conditions for long-term funding. Credit spreads for bank bonds have risen sharply.

And all this against the background of securitisation markets which remain virtually closed and a US-housing market which has still not hit bottom.

Immediate measures taken by governments have contained the crisis. There was no way around these. Too much was at stake – not just the existence of certain banks. Without the help of the state a systemic collapse was likely.

It is difficult to assess already how effective these steps have been – all the more since global growth prospects have recently deteriorated rapidly.

The good news is: capital injections have recently exceeded credit losses.

By the end of 2008, 4% more capital had been raised than losses were reported thanks to government packages. My only fear is that the 750 billion US\$ credit losses reported so far do not yet reflect the full deterioration of credit quality.

And rising unemployment will increase default rates on household debt.

With this in mind, it was wise that the financial rescue packages were accompanied by a number of economic stimulus packages – on national and European level.

But even if the rescue packages were unavoidable and the economic stimulus was necessary, a first set of questions arises which may be worth discussing:

- Considering the amount of resources for these measures which will have to be funded via capital markets: will government guarantees and the governments' huge need for capital not crowd out other borrowers?
- Will government capital injections not raise the benchmark for capital levels at all banks?
- Since government measures have been designed in different ways and with different objectives, are these differences not already distorting competition?
- And how can EU competition policy keep its head above the tide of market distortion which may arise from further rescue packages on an even larger scale?

I don't have the answers to these questions, but I think they must be discussed once the immediate damage has been averted.

Besides these considerations with their roots in the short-term intervention measures, there is a second set of issues deriving from problems that became obvious in the run-up to the crisis.

To name all of them – ranging from risk management to accounting, from banks' remuneration policies to OTC market infrastructures – would be too ambitious an approach. So I will not even try to be exhaustive. Let me just mention three issues I find important:

1. More transparency is needed

I know that "transparency" is among the most overused expressions in the current discussion. Nevertheless – one comment and one recommendation:

The European financial industry has successfully worked towards increasing transparency in the securitisation markets. This is being achieved by drawing up disclosure best practices for the so-called "Pillar 3" of Basel II and by improving information tools for investors. This is a remarkable step.

But it may not be enough. If I were in the shoes of a supervisor, I would focus on the following issue, too:

The statistical data furnished by central banks and international organisations provides a broad basis for analysing the financial markets. Nevertheless, not enough data is available at present on important aspects of international finance. For example, total leverage has not yet been documented, nor are there any official statistics on the secondary market for securitisation.

Further sets of data should therefore be compiled. In addition, more consistency between national and international statistics is needed. I could well imagine that the additional bureaucratic burden would be considered bearable by financial institutions – especially if they got back aggregated data for their own purposes.

2. More capital is needed in the system.

But: all measures should be closely aligned with the respective risk. In this sense I am sympathetic to the idea of raising capital requirements for certain complex structured credit products and for credit exposures in the banks' trading book. And I support proposals to strengthen the capital treatment of liquidity facilities to SPVs and conduits.

But I don't think it would be useful to introduce risk-independent "one-size-fits-all" capital cushions. They are blunt instruments that ultimately even risk making loans more expensive.

I hope these ideas will play a role in the discussion on the CRD review.

3. The structure of supervision must follow the structure of the markets.

Market integration has created cross-border groups which are managed in an integrated manner. But the supervision of these banks has not kept pace. The model of pure cooperation between supervisors is not enough and regulatory and competency gaps remain.

The Commission's proposal to set up colleges of supervisors and give the parent institution's supervisor certain new powers was a step in the right direction. This approach mustn't be skipped but must be supplemented by similar international colleges and – in the long term – a European system of supervision. I hope the findings of the "de Larosiere" group will reflect some of that thinking.

Ladies & Gentlemen,

some of the issues I mentioned can be solved on the EU level – others may have a global dimension.

I would not like to end without one final remark in this context:

We have created a coherent framework for financial markets in the EU. This strengthens our common interest: Europe can gain in political clout if we follow coordinated strategies. Then we can influence the shape of the policy debate.

In some areas we are already there: the conclusions drawn up by the Financial Stability Forum and the G20, for example, reflect this. They are very close to what we called the ECOFIN crisis roadmap.

Whatever issues may arise in the coming months – we should remain in formation, so to speak. It is my firm belief that going it alone will have harmful effects on all of us.

This is not to say that we should construct a "Fortress Europe". Yet I regret to say that I see some signs of such a development:

Two examples:

→ OTC CDS platform: such central counterparties might gain importance as a mechanism to mitigate risk in OTC CDS markets.

It is therefore a welcome instrument with the potential to improve the stability and transparency of the OTC market. With this in mind: is it really such an urgent question whether the CCP should be a European, euro-zone or other solution?

→ CRA Regulation: in their present form, Articles 4.1. and 4.2 of the regulation would have the ridiculous effect of allowing EU banks to sell unrated bonds to their customers while placing regulatory hurdles in their way if a security was only rated by, say, a Canadian rating agency. This is surely not what EU legislators intended. Ultimately, business of this kind would migrate to other financial centres.