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*Special Committee on the Financial, Economic and Social Crisis*

**PUBLIC HEARING:**

**The causes of the financial crisis and the consequences and challenges for the European Union**

Brussels November 10, 2009

Good afternoon and thank you for this opportunity to share with you some ideas on the origins and lessons of the financial crisis. My main conclusion, let me advance it to you, is that we need a new rule-based setting to prevent, minimize and eventually deal with financial crisis.

I will not take much time on the analysis of the causes of the crisis, which has already been covered by previous speakers. I share basically Mr. Sapir's comments with one additional point. It is the excessive growth of credit that has resulted in the crisis, as it is always the case with financial crisis. The credit bubble resulted also in over optimism across the board and in a gross underestimation of risk, specifically systemic risk. Suffice to say that the crisis is the result of misbehavior by all participants in financial markets, investors, banks and regulators alike. Therefore I will go directly to the lessons that can be learnt from this crisis, lessons that should lead to concrete actions. The spirit of the presentation is not to increase the regulatory burden on financial institutions but rather to establish better regulation. There are two dangers in the current situation. One is that of coming out with excessive regulation. The other one is to let reform momentum go by as the worst part of the crisis seems to be behind us.

Let me organize my ten minutes in four topics: central banking, financial regulation, financial supervisions and international financial architecture.

## **1. Central banking**

- Monetary authorities that are also supervisors work better in case of systemic crises. Price stability and financial stability are two CB objectives not always easily compatible. Bubbles are created when monetary and credit conditions are too loose for too long.
- Central Banks should be in charge of regulating and supervising at least systemically important financial institutions.
  - The US is moving ahead. The EU lacks ambition; the de Larosière report is too politically correct and misses the point.
- Transparent and clear rules should help isolate Central Banks from political pressures and enhance their accountability
  - Redefine and restore the importance of traditional money supply growth targets
  - Accountability of central banks should be enhanced by using simple and transparent early warning indicators (like credit growth) together with “correct or explain clauses”.

## **2. Financial regulation.**

- A macro-prudential pillar under capital/solvency rules is needed to account for systemic risk. Financial firms should be encouraged to adopt business strategies that promote greater financial stability by internalising their contribution to global systemic risk (no free riding).
  - Instead of prohibiting financial innovation, those aspects of bank strategies which are considered to cause negative externalities to the system should be charged extra capital requirements.
  - This new pillar would be countercyclical thus making capital requirements tougher during expansions and easing them during contractions
- There is a need for a stabilising mechanism for money markets similar to deposit insurances (FDIC). Retail financing has proven to be more stable than wholesale financing.
  - Under this mechanism, only in case of systemic crises, the governments and central banks commit to provide emergency liquidity and to guarantee new bank liabilities.

### **3. Financial Supervision.**

- Supervisors should have the capacity to intervene pre-emptively, gradually and with legal certainty when the solvency of financial institutions or the stability of the system is threatened.
  - The cost of banking crisis is lower the sooner the intervention takes place.
  - Government rescue operations should reward prudent behaviour and do not damage the competitive position of well behaved institutions which do not need public support
  - This crisis has revealed the problems related with rescuing international “mega banks. The “too big to fail and too big to be rescued” problems.
    - Size does not matter as much as the risk profile
    - International crisis management need be reinforced by pre agreed and binding commitments by the different governments in which a megabank operates.
- There is a need for an internationally agreed common framework to rescue viable institutions during systemic crises. To avoid negative externalities and provide information to the market, a common rescue package should follow the following principles:
  - Transparency
  - Maximum efficiency and taxpayer protection in the use of public funds
  - Minimum public sector involvement in banking management
  - Use prices generated by competitive procedures among private parties
  - Clear exit strategy
- This would lead to Public Private Recapitalisation programs by the public sector leveraging up on private funds.

#### **4. International Financial Architecture**

- Current institutions functioning properly are enough. There is no need to create new ones.
  - Improve their functioning, effectiveness, governance, financing, and political legitimacy, clearly defining and allocating their responsibilities and strengthening coordination between existing bodies.
  - Build on current trends, the Financial Stability Board to define international norms and regulations and the IMF to act as the oversight and auditing body. For instance, make FSAP mandatory and public.
- Real financial market integration in Europe requires a single European voice in certain international institutions like the IMF. This would require substantial quota revisions to the point where the European Union would have the same quota as the USA making room for large emerging economies.