CHECK AGAINST DELIVERY

Speech by Sharon Bowles MEP
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Supervision and the European Supervisory Architecture

Thank you very much for inviting me to speak here today, though of course I am no stranger. A few of you will know I also spoke at the Lead Conference yesterday and that speech is also available.

The European Supervisory Architecture is on the point of taking off. Some worry that it is being asked to run before it can walk, others would rather have given it powers to fly: I believe that there is great potential for us to make the architecture a useful tool that should enhance the single market in financial services. There will be pitfalls and challenges before us and I would like to highlight those attracting my attention.

First, the creation of the Authorities is not the end of the story because the Authorities, and in particular ESMA the markets authority, will be populated by responsibilities that are given in sectoral legislation. Already we have roles being given for direct supervision of credit rating agencies, responsibilities in the draft for the European Markets Infrastructure Regulation relating to OTC clearing, CCPs and Repositories and also a role in the recently agreed AIFM directive.

In the creation of the ESAs, the Parliament wanted a strong role. We had long been concerned that the level 3 committees did not have enough power and sometime before De Larosiere's report was commissioned we had developed proposals for a mediation role within our own reports and in Solvency 2.

We were also very keen to ensure that the three ESAs worked closely together – indeed as you will all know there was a preference in the Parliament for a single Authority and this is one of the subjects for eventual review. We also put a high priority on the Joint Committee, because financial markets and institutions are complicated: they interact with one another and operate cross border. Not everything can be pigeon-holed as banking, securities or insurance and pensions. Each must be aware of the other for interactions and perverse effects and know when to hold off, when to copy and when not.

And this is before us right now. Decisions that are made in the sectoral legislation underway und upcoming on markets will have an effect on the prudential side. One of the big issues – that of EMIR and regulation of CCPs is acknowledged to require input of the EBA not just ESMA.

Indeed staying with that for a moment, EMIR also makes proposals concerning colleges, with the college moving from being a forum for decision making by national supervisors using national powers, to being itself a key decision taker. In EMIR a home Member State must secure a joint positive opinion from the college – and potentially also from ESMA – before authorising a CCP. If there is no decision in the college then ESMA ends up taking a binding position over a college that has a wider knowledge and competence than markets (or ESMA) – for it will include prudential regulators and central banks.

So immediately there is a situation where the need for cooperation in a cross sectoral way, and before the legislation is finished I hope that we will manage to reinforce this. But is also shows the potential importance of the joint committee and in the Parliament we are concerned that two people from each ESA on that committee may not be enough.

Now one of the first things that happened after the final agreement on the supervisory package was that the Basel Committee published its latest proposals. Almost immediately there were many calls for exemptions on the basis of EU specificity. Now I have my own problems with Basle 3 – which may differ from those of savings banks and others – but what this highlighted for me was that if we continue to create regulation in a way that establishes carve outs and exemptions, it is fundamentally putting sections of our markets beyond a common rule book, and with that I would say beyond a common understanding. We need to turn our thinking around on this and put understanding ahead of exemption.

In other speeches recently I have explained how maybe there had been insufficient transfer of understanding, and therefore of regulation, for example from UK markets into the EU. If the UK had exported regulation of hedge fund managers, retail conduct of business rules, lower shareholder ownership thresholds and disclosure of contracts for difference the approach to AIFM might have been less frenzied. So I welcome that CESR is now recommending many measures to the Commission that have been used in London, because that is what a common rule book demands and it is what common understanding demands.

In times past it might have been right that everything the UK did for regulation of the City was not needed elsewhere – but times have changed now. If more comprehensive rules are to be made at EU level, and including decision making roles played by ESAs and colleges, then everyone making and voting on those measures has to have a comprehensive understanding at the highest level.

Before you get the wrong idea, I am not saying that EU legislation or the approach of the ESAs has to be to add together A to Z of what everyone has done; I am saying there must be a much greater understanding of A to Z and different approaches.

The task of the new authorities will be difficult. The staffing levels are not huge, and there are still questions for many about how it will interact with career structures in national authorities, and pay levels present challenges here if the best are to be attracted. I hope that these start up problems get resolved – and that the working links with the national regulatory authorities foster an atmosphere of inclusiveness and trust.

So the authorities are coming to life in a challenging environment and they need to have adequate resources to deliver what we expect from them. There is no escaping the fact that for this the new ESAs will have to rely extensively on resources from national authorities – both in terms of their policy-oriented work and also in terms of hands on aspects of supervision of credit rating agencies and any other powers that they may be given.

But delivering a more stable financial system requires more than better rules and a new European supervisory architecture. We must not loose focus on the importance of the supervisory effort at all levels in ensuring that the reforms are effectively delivering what we set out to achieve.

Therefore supervisors at all levels, national as well as ESAs, will need to have adequate resources – in terms of numbers of people who are charged with the implementation of the new regulatory regime and also in terms of the quality of supervisory staff. I recall writing into Solvency 2 phrases about supervisory capacity and expertise, and that was not done so it could be ignored and then compensated for by upping prudential requirements that put at risk the availability of insurance. For the citizen there is no insurance as unsafe as not being able to afford it.

While much is being done to de-risk the system through regulatory requirements, the other side of that is that supervisors must be well-equipped in terms of knowledge and understanding of the risks to make the right decisions. This requires a significant degree of closeness to markets and their participants, it is why national regulators are crucial to success and also why in the new environment there has to be more sharing of intelligence. At the same time we need to ensure that this does not result in regulatory capture, or excessive similarity in regulatory thinking, or 'group think' as some call it.

I still remember the shock with which I first came across correlation factors, assumptions on independent variables and tail risk treatments in finance – and probably so do many of you because I kept going on about it – because they did not fit with how I would have approached it from an engineering mathematics stance. This is one reason why in the supervisory architecture the Parliament insisted on the European Systemic Risk Board having outside expertise in a scientific committee, and

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I sincerely hope that when these appointments are made the net is cast wide enough beyond financial mathematics.

And right now I can return again to my engineering mathematics, and history, by pointing out the well known fact that if soldiers march in step over a bridge, it resonates and collapses. I am concerned that the risk averse patterns we are building, where different views that should create smoothing are outlawed, may be dangerously akin to marching in step over a bridge, creating pro-cyclicality and systemic risk rather than preventing it. All that has changed is that it is a new bridge.

It is considerations such as these that we also expect to be examined by the other part of the architecture, the European Systemic Risk Board. Looking for future asset bubbles may be the easy part of its work which will cover matters from too big to fail or manage, through all kinds of collective results from individual and micro-prudential actions. I have seen maturity transformation also flagged as an issue, and it is interesting that something that once, I thought, was a fundamental reason for banks is now talked of in some quarters as a problem.

So what are some of the more detailed challenges for ESAs?

First what range of action can the ESAs actually have? We are already embroiled in further analysis of the Meroni case, which basically says that Agencies cannot have wide discretionary powers. Here there are conflicting views on what constitutes 'wide' and also what constitutes 'discretion', if we want to be more pedantic then we are left looking at the various interpretations of what is meant by 'which may, according to the use which is made of it, make possible the execution of actual economic policy'. I have my own views on this and unfortunately so do a lot of other lawyers.

Overall I think it needs a good dose of common sense and interpretation in the light of financial services. If we are serious about the ESAs how can we possibly move forward if they are bound by interpretations such as not having the power to 'determine whether, when and how to act' or not be charged with 'weighing of interests'. These are arguments that are live now with respect to the fines on credit rating agencies, which if I may say so is a lot less fundamental than some of the other issues we all thought ESAs might be involved in such as capital surcharges, other incentives to firms and balancing public policy requirements such as risk and efficiency.

And this alleged bar on discretion would apply not just to direct supervision but also to the other roles of the ESAs.

Going further how can you charge a body with powers of binding mediation, then tell it that it has not power of judgement or weighing of interests? How are we ever going

to get to grip with proper understanding of methodologies, or in Solvency 2 the approval of internal models. Indeed what is the point of understanding anything – which I said was pretty crucial to do, from A to Z – if you cannot use the fruits of your wisdom. Are we saying the ESAs merely apply a legalistic tick box set of rules of the type that so categorically failed and contributed to the crisis? I do not see worries about issues such as this helpful to trying to attract calibre people to the ESAs.

I may make myself unpopular, but if we cannot get to grips, soon, with a better consensus, with fewer reservations of position from the Commission, we may as well refer the matter to the ECJ.

I mentioned CRAs in the context of fines and the examination of Meroni. CRAs challenge in several ways, the approval process, the supervision, and also the liability regime. Investors, including insurers of course, are now being encouraged to do their own due diligence – which is a good thing. But they can also claim that they used a credit rating agency and sue if the prediction is wrong. This seems to open up the possibility of what I might dub 'litigious speculation', a new kind of hedge. And if the requirement to use a rating comes from legislation, then surely that puts liability on to the regulators. Seems a bad deal at the ESA level, especially if they had no discretion! I cannot help but feel that on CRAs we may come to own the phrase 'be careful what you wish for'.

ESAs and the ESRB will be involved in data collection. There is a lot of this about now and care has to be taken that we do not collect data for collectings' sake and give a false sense of security or submerge useful data. Data is no good if the resources and plans to interrogate it do not exist. So rather like the saying to tax without representation, we should think 'no data without interrogation' – although I will concede that some interrogation may be in response to events not routine, so I suppose I am really saying 'without interrogation techniques'.

The ESAs must also look wider to the international situation and here the role of colleges of supervisors is both important and maybe in need of refinement. I am on record as having said I was disappointed how little colleges featured in the debates around supervisory architecture, their main mention coming in the context of concerns confidentiality of information. But we have to ensure that we take account of the situation where a group may have substantial, or even a majority, of its interests outside the EU. What then is the role of the ESA with respect to the college? It would indeed be unfortunate if we force the development of apartheid where a group has to be either 'European' or 'International' but cannot be both.

As this is a CEIOPS conference I will end on Solvency 2, although you discussed that this morning. And of course there is a lot of other upcoming work on pensions and marketing, both specific to insurance and generally, that is relevant.

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Many of you will know that I have often raised my voice to say that there are big differences between insurance and banking, and I still hold reservations that there is from some quarters a tendency to copy banking, not least in adopting the same risk averse characteristics - which to my mind is the latest ‘group think’ that when viewed at the macro rather than micro level risks being the same as marching in step over a bridge.

Insurance survived the crisis, but is now severely affected by the actions taken to enable banks to survive which are hitting yields and returns. It is an unjustified ‘double whammy’ then to treat insurance as if it were banking, giving it all the downside when it had none of the help.

So it was gratifying yesterday in the Lead conference when I think we got to the position, myself and Carlos, of agreeing that Solvency 2 was still ahead of Basle 3, and I agreed also with Carlos’ analysis of some of the regulatory dangers. So although I have at times said harsh words to CEIOPS about sticking within the level 1 framework of Solvency 2 - and I will keep watching - we share a lot of common concerns and ambitions. The development of the implementing measures is a bit of a journey and we are not yet there. However, by being practical and pragmatic - and paying heed to the proportionality that the Parliament put at the heart of Solvency 2 - a good result should be within our grasp.

Thank you for inviting me here today, and I look forward to the presentations and discussions in our panel session that follows.