EIOPA Conference – 19 November 2014

Frankfurt

It is a pleasure and an honor for me to address the 2014 annual EIOPA Conference.

You know that the Committee that I chaired in 2009 proposed the creation of three Financial Authorities in Europe. I am all the more happy to participate in this EIOPA Conference that the Authority responsible for insurance is playing such a significant role in regulating and supervising this important sector.

I will divide my remarks into two headings:

- A few thoughts on global financial markets since the crisis;
- Views on regulatory issues in Europe

& &
&

I. A few thoughts on global financial markets

1. The financial crisis was essentially the product of an excess of credit

The volume of outstanding credit worldwide has increased from some 20 trillion dollars in 2000 to 50 trillion in 2014 (increase of 2,5 times).

During those 15 years, credit increased on average by 15% annually while economic growth hovered around 5% in nominal terms (2 to 3% real). This divergence between the expansion of credit on the one hand, and economic growth on the other is relatively new (there had been traditionally a direct link between credit and growth) and is the sign of the explosion of the financial sphere.

Monetary policy has played an important role in this development: interest rates (calculated in terms of 10 year nominal premia on public bonds) declined from 2% - 3% to minus 1% during the period (0 being achieved in 2010).

When interest rates verge towards 0 or to negative real rates, it is not surprising that this contributes to a surge in borrowing. That surge, given the amount of liquidity created by central banks, was accompanied by very low risk premia. This under pricing of risk was eventually one of the main triggering factors of the 2007-2008 financial crisis.

2. Since the crisis, the global amount of outstanding credit has continued to increase albeit at a slower pace.

Private credit (in relation to GDP) has increased from 170% in 2007 to 200% in 2014 (i.e. 15% increase in seven years).

But what is interesting to note is that this continued expansion has its source in credit to emerging countries[1], while bank lending to Eurozone enterprises has declined by a factor 2% per year since 2012.

Lending to EU residents is declining while European banks are increasing credit to non residents.

This is the manifestation of a shrinking of the credit channel to the real economy in particular in a large part of the eurozone. This trend has, as we well know, a demand led dimension (necessary deleveraging after a period of overextended borrowing) but also a regulatory aspect (the rapid increase – two to three times- of the equity base of the banking sector in the advanced economies was bound to have a restrictive influence on the size of assets).

3. Can we say that the financial sector is stronger and better adapted than it was before the crisis?

To a large extent the answer appears positive: the capital absorption capacity of banks has increased and standardized derivative transactions are being brought into organized and transparent platforms.

But there are also nagging issues. One is the limitation of volume and duration of bank lending and more precisely the fact that bank balance

1 China has seen its money supply multiplied by three times since 2008

sheets are more and more driven by the specifics of regulation rather than by economic needs.

More generally, while the major problem before the crisis was excess debt and insufficient equity, nothing in regulation has promoted equity versus debt. On the contrary, equity is actually discouraged tax wise and for regulatory reasons. Credit maturity is shorter (NSFR), outstanding repos are reducing (Leverage ratio), holding of sovereign assets (0 risk) is encouraged (LCR) to the detriment of private loans considered more risky by regulators and equity holding is discouraged (CRD4, Solvency 2, IFRS).

Is this what we really wanted? Or is it the result of different pieces of regulation of which the cumulated global effect has not been sufficiently understood in a holistic way?

I will now focus on a few aspects of regulation.

& &
&

II Regulatory issues

1. The new wave of banking regulation is inevitably going to reduce the lending capabilities of the EU banking sector

The combination of the recently announced NSFR, of the projected increase of the non risk-based leverage ratio, and of the TLAC will have a further significant impact on the profitability of EU banks which is already very poor.

It is too early to calculate precisely the economic impacts of these projected new rules. Indeed the outcome depends of the results of the final negotiation as well as on the P&L and risk profile of each Global SIFI.

But what is sure is that European G - SIFIs will inevitably be obliged, at the end of the process, to reduce their assets. Indeed, given their low level of profitability, they will be confronted with the following problem.

The marginal cost of additional capital will have to be compared to the marginal profitability of bank lending. Because of the present conditions in terms of cost of capital (around 10%) and the current low level of profitability of EU banks (around 5%), there is no way that the equation can be solved exclusively by raising new equity: there **will** be a reduction in assets even if this will be differentiated according to each institution.

In a sluggish economy as the one we have today in the Euro area, which is dependent on banks for ¾ of its financing, this new wave of regulation, is going to affect very specifically the European banks which on top of that do not benefit from some of the US facilities (like GSEs).

We will therefore see a reduction in the size of G SIFIs. This is intended to avoid the repetition of the too big to fail danger. Unfortunately this medication does not seem well adapted to the continental European universal model which withstood the crisis pretty well without significant losses (losses of the size of 20% of RWA as envisaged in TLAC have never been observed in the euro area during the crisis!).

The concentration of additional capital requirements on global SIFIs raises a question: are we sure that smaller banks – exempted from TLAC – will also be "exempt from failing"?

Be it as it may, all this leads to a necessary shift towards more market based financing solutions in Europe. This is the idea behind the Capital Market Union project. Since banks are inevitably retrenching, alternative forms of financing have to be developed. This is a major challenge for regulators and decision makers: organizing a transition towards a more diversified financial system in Europe. It will take time and will have to be carefully thought through.

2. A case in point is securitization.

Securitization is a way to substitute – or to add – market finance to bank lending. The regulatory framework is a key element of the success of securitization. The Commission has just published the delegated acts of Solvency 2. Capital charges for senior tranches have been capped to 3% which is a positive development.

- I understand that beyond this standard approach, there is a consensus to adopt a "look-through" approach, as proposed by EIOPA, which would allow insurance companies that use internal models to be subject to a lower capital charge based on their own analysis of the risks incurred.

- While senior tranches have been recalibrated, this is not the case for junior tranches which have kept their initial capital charges. This results in a widening of the difference of treatment between senior and junior tranches. The minimum level of capital required for junior tranches at this stage is 12,5% up to 19,7% for a BBB junior tranche per year of duration. The mere widening of that gap raises regulatory arbitrage issues.

- Under these proposals, securitization tranches presenting a similar risk of loss to investors would receive a different capital treatment depending on their seniority.

  For example, tranches with an identical A rating would be subject to different capital treatment depending on whether they are mezzanine or senior tranches even though they present a similar risk of loss to investors.

  This would produce undesirable effects and impact the efficiency of securitization as a financing tool.

In effect we suggest that the Commission and EIOPA better align the capital charges to the loss expectations and not to the position - senior or junior - in the waterfall of the tranches. Otherwise, it is the position - junior versus senior - that becomes the driver of high capital charges. In that case, the risk is that the securitization will not be marketable to others than unregulated companies.

The current approach of regulation on securitization is that insurers act like traders with their investments and are exposed to market risks in the same way as traders. That is to say they are always and fully exposed to market price volatility. But this is not true as their business model allows insurers to reduce significantly or even fully avoid exposure to forced sales. Moving towards an alignment of capital charges on counterpart risk would make a significant difference. For example, the actual

accumulated defaults rate for high quality AA type securitizations during the entire crisis period was only 0,14%. The current Solvency II charge would be 100 times higher.

Therefore I suggest that the Commission and EIOPA have a second look at this issue which is not just a technical one. Indeed, in the real life, packages of SME credits will contain mezzanine tranches that must not be exaggeratedly penalized (risk wise) lest they would lose their marketability. What we are asking for is not a regulatory "advantage". It is just neutrality. We are at their disposal to study the matter and make constructive proposals.

3. The role of EIOPA is a essential in the development of a strong and stable insurance sector.

I would like to recognize the remarkable action deployed by EIOPA under the leadership of Gabriel Bernardino. This Authority has been a main driver of the policies geared to create in the insurance sector a rational setting in terms of risk based prudential regulation. EIOPA has made a significant contribution to a better adequacy of the framework to the long term features of insurance business models in particular by a better matching between assets and liabilities.

I would also like to strongly support EIOPA 's emphasis on the need to better harmonize not only regulation but also supervision.

In order to achieve this it is essential that:

- EIOPA has sufficient powers to conduct inquiries in particular financial institutions and not only in a situation of crisis;

- EIOPA has an appropriate independent budget line that ensures sufficient flexibility in the way it can carry its tasks.

This allows me to make a final remark that will not surprise Mr Bernardino, and I know that he will forgive me for expressing it.

In spite of the progress made in the Solvency 2 framework, I am still uneasy with the capital treatment of long term instruments which, in my view, tends to discourage equity and infrastructure investments because

duration or volatility are considered as the main drivers of risk rather than the intrinsic risk of the asset.

More generally, it seems to me that one should pay more attention, when determining capital charges, to the expectation of default (thus capturing counterparty risk) in particular when the assets are matched with long term liabilities, rather than mainly focusing on market volatility[2] or seniority.

Thank you for your attention.

Jacques de Larosière

[2] The treatment of SME credits for example should be aligned on the mortgage capital methodology.