Building a New Financial Architecture
Lisbon, 26 April 2010

New regulatory requirements

Elemér Terták
Director

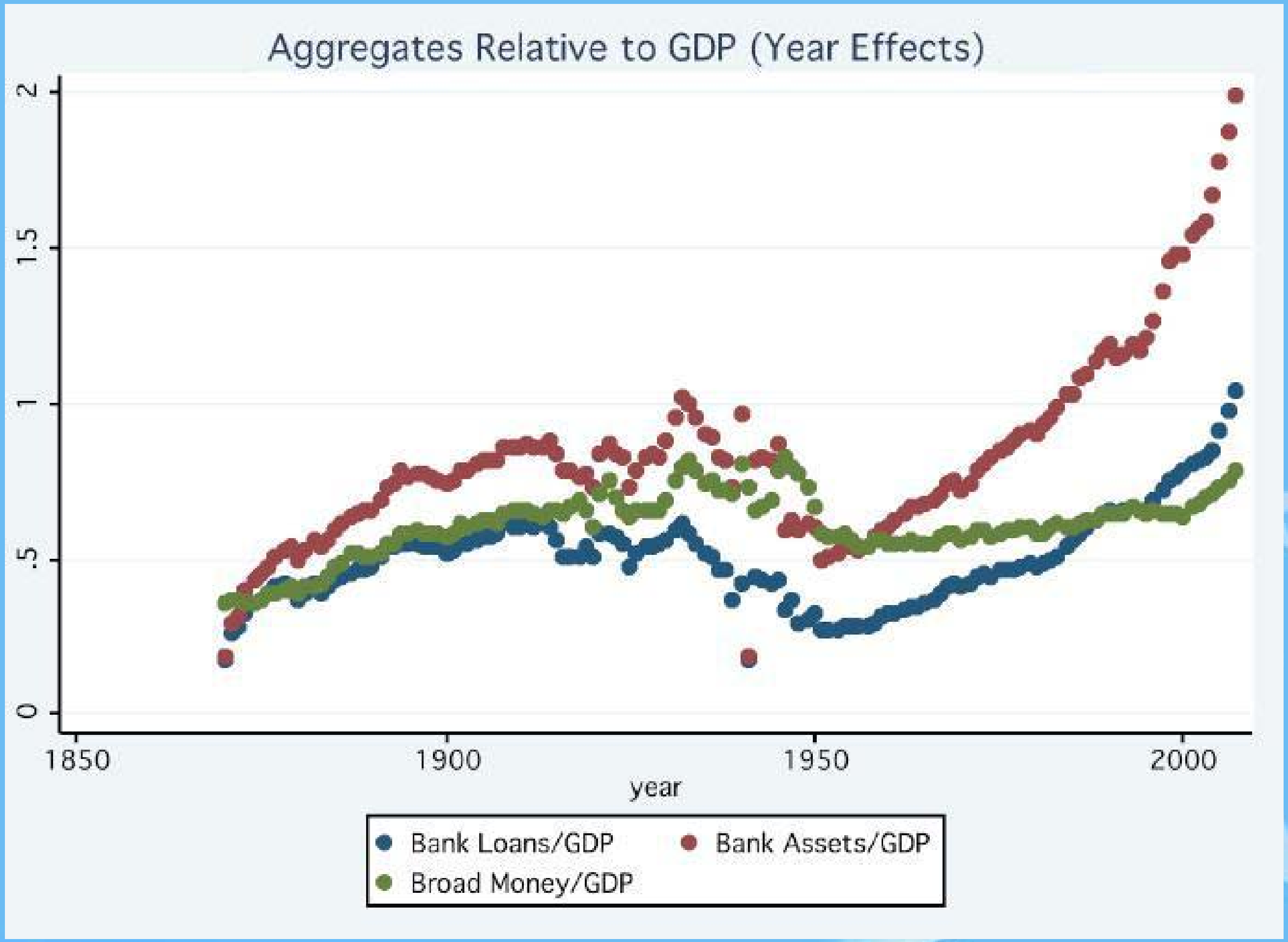
European Commission
DG Internal Market and Services

Changes on the markets

Retrospectively banking underwent in the recent half century major changes:

- Leverage increased more than tenfold (50% since 2000!);
- Savings and loan patterns changed;
- Innovation accelerated & new products (credit derivatives & securitisation) were developed;
- Trading volumes exploded;
- Markets became global by deregulation and technological (IT) progress

Increasing leverage



The problems

- Financial sector was not prepared to all this changes;
- Furthermore was also not able to withstand a substantial macroeconomic volatility.
- Consequently EU MS had to provide guarantees and capital injections equalling 25% of the GDP, while Central Banks had to provide several hundred billions of extraordinary facilities to preserve the entire banking system.

The roots

- But why they took such huge risks if they were not prepared to cope with them?
- Two possible answers:
- Either they understood the risk but went ahead because it suited then;
- Or they went ahead, because they did not understood the risks.

Options	Paradigm
	Agency paradigm Taking advantage of asymmetric information; capturing upside, leaving downside to others
First	**Collective welfare paradigm** No ill intent, but focussing on private cost and benefit not equal to society
Second	**Collective cognition paradigm** Difficulties to understand the dynamics and interconnectedness of the system

Problem was that regulation followed piecemeal approach, focussing on one aspect (paradigm), thus causing additional problems elsewhere

What caused the problems?

Problem was that regulation followed piecemeal approach, focussing on one aspect (paradigm), thus causing additional problems elsewhere.

Pillars of regulation

Prudential	ex-ante	Aligns principal-agent incentives
Safety net	ex-post	•Deposit guaranty •LOLR
“Line-in-the-sand”	both	Reliance in perfect markets, self regulation, corporate governance

The future regulation

- Will be more intrusive and onerous;
- Requires more disclosure and transparency;
- Will be more holistic and focus on systemic risk (size, interconnectedness, substitutability, and speed of loss transmission to third parties.)

Implications

- Perimeter of regulation & supervision increases
- Constraints on financial institution (higher expectations)
- Intense global coordination (align rules, prevent regulatory arbitrage)

G20 answers

Principles	Immediate	Medium Term
Reinforcing international cooperation	2	2
	15	***15***

CRD II	CRD III	CRD IV
Large exposures	Trading book	Liquidity standards
Colleges	Remuneration	Definition of capital
Hybrid capital	Resecuritisation	Leverage ratio
Liquidity risk management		Countercyclical capital framework
Securitisation (retention)		Counterparty credit risk
		SIFI
		Single rulebook

Are all risks covered?

Basel II ratios do not explicitly address:

- Concentration risk,
- Funding liquidity risk,
- "Tail" risk,
- Strategic risk and
- Reputation risk.

These risks are excluded from Basel II ratios because of a regulatory desire for tractability and quantification challenges, and a view that minimum risk-based capital requirements are not necessarily the optimal solution for addressing every form of risk. However, banks are expected to identify, assess and manage these risks under Pillar 2 of Basel II.

Further regulatory initiatives

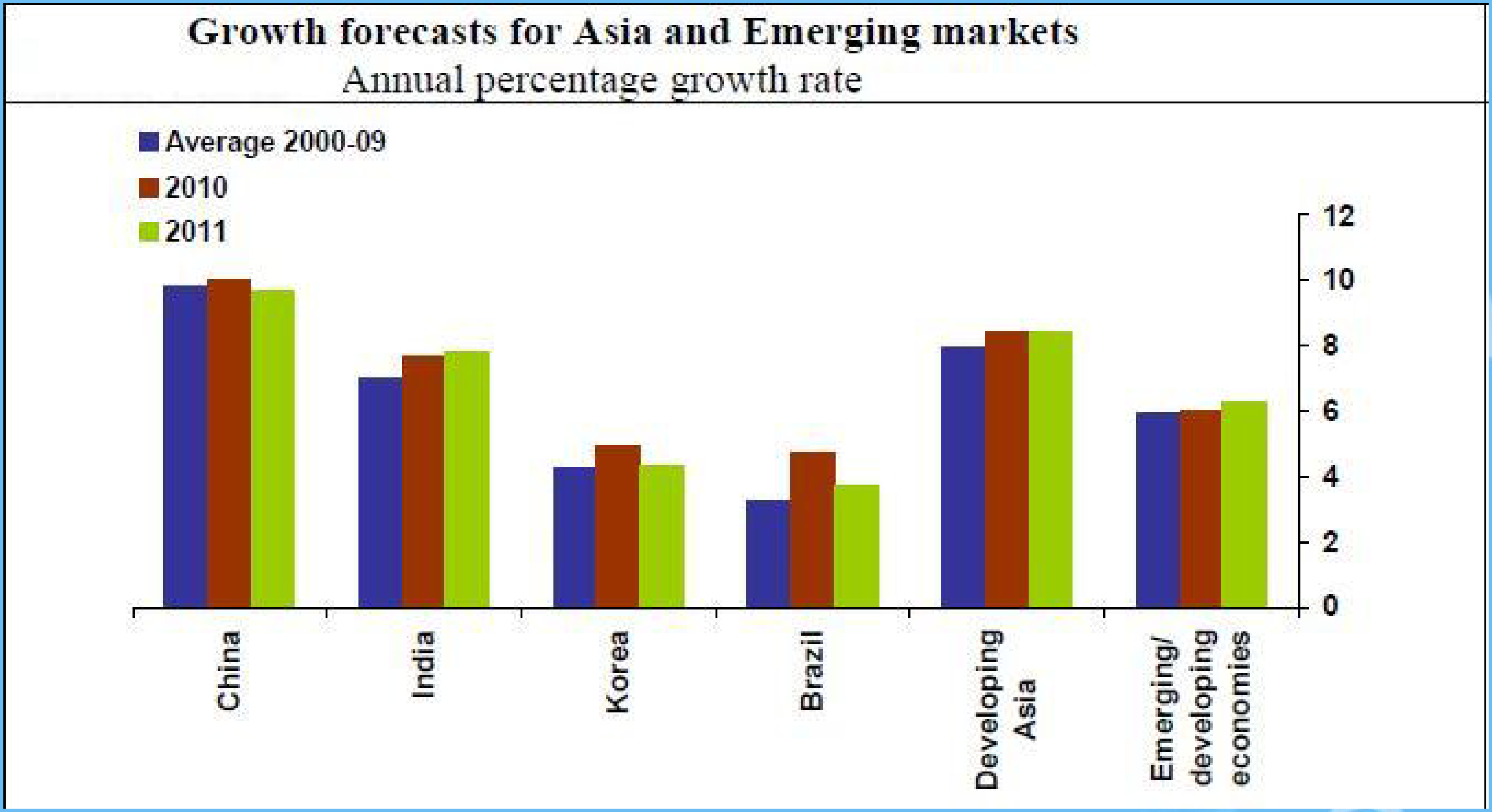
- Supervision (ESRB / EBA+EIOPA+ESMA)
- CRA
- AIFM
- CCP
- Derivatives (CDS)
- Deposit Guarantee System
- Crisis management and resolution framework
- Taxation of banks / resolution fund
- Accounting practices
- Exit strategy

"**O óptimo é inimigo do bom**."
The very best is the enemy of the good.

Five substantive forces that will change fortunes of banks

- Capital shortage triggered by the crisis will endure and get worse.
- High and rising cost of long-term funding.
- Returns will be weak by the standards of the past decade and will be highly uncertain.
- The balance of power shifts abruptly and powerfully rather than gradually; Asian banks vault to the top of league in one go.
- Emerging-market giants, riding the back of faster GDP growth, will outperform developed-market universals.

Emerging countries



Thank you for your attention!