Speech

Living on borrowed time

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Introduction

I am very pleased and honoured to be here to celebrate with you the 25th birthday of the the Comissão do Mercado de Valores Mobiliários (CMVM). In my previous responsibility as Chairman of the Authority for the Financial Markets (AFM), your Dutch sister organisation, I worked closely with the CMVM. Carlos Tavares and I met on a very regular basis in the context of the Committee of European Securities Regulators (CESR), later the European Securities and Markets Authority (ESMA), and the International Organization of Securities Commissions (IOSCO) and through our joint responsibility for the supervision of Euronext. I always greatly appreciated the quality of the work and the people of the CMVM. I wish the CMVM a future which is as bright and promising as the past 25 years.

Of course it is especially nice that this event still takes place under the Chairmanship of my good friend Carlos Tavares. Carlos and I go back to mid-2007, when I became chairman of the AFM. These were the darkest days of the financial crisis in which the global economy came close to collapse. These were frightening, but also fascinating, times and I always enjoyed discussing the issues with Carlos and getting the benefit of his insights and his broad experience.

We are now nine years on and Carlos asked to use this opportunity to look back on what has been achieved since the depth of the crisis in 2008. I will take stock of a few highlights of the regulatory progress that has been made and of the challenges that remain ahead. My advance warning is that I cannot guarantee that all of my presentation will lift your spirits. I fear that developments in the global economy in the coming years will remain fascinating. Far too fascinating.

Since I will stray outside the remit of the International Accounting Standards Board (the Board), I should also make clear at the outset that the views I express here today are in a personal capacity.

Accounting

But let me start out by sketching some real progress that has been achieved in the regulatory field. Given my responsibilities as Chairman of the Board, you will forgive me for starting with accounting.

First of all, despite the financial crisis, the use of IFRS Standards around the world has continued to advance with great dynamism. The only disappointment in recent years was that the use of IFRS Standards in the United States has not progressed further. But this has not really affected developments in the rest of the world. Currently, 119 jurisdictions use IFRS Standards, lock, stock and barrel, while many others permit their use. China, India and Japan have recently made great progress towards the use of the Standards. IFRS Standards may now have become the most widely and uniformly used international economic standard. This has brought, and will continue to bring, tremendous benefits to the global economy in terms of transparency, accountability and efficiency.

Also in terms of standard-setting we have made a lot of progress. We have delivered a more solid revenue recognition Standard, a leasing Standard that marks the end to off-balance sheet leases and an urgently-needed insurance contracts Standard is close to completion.

The completion of IFRS 9–our financial instruments Standard–was our main response to the financial crisis. The replacement of the incurred loss model with a more forward looking expected loss model will make it much more difficult for banks to 'pretend and extend'. Full lifetime losses will have to be recognised as soon as a significant increase in credit risk has taken place. We have made clear this is an event that takes place well before a payment is missed.

Until now, pretty much every accounting framework in the world has been using an incurred loss approach, including IFRS Standards and US GAAP. However, in practice this Standard has been applied with some level of variance. Different jurisdictions seem to have taken different stances on when losses were considered to be sufficiently certain for those losses to be recognised. In some jurisdictions a regulatory overlay seems to have taken provisioning beyond the scope of the accounting standards. In others, banks recognised losses too little, too late. There seems to have been no strong reaction from auditors and market regulators in the light of this diversity.

IFRS 9 will take effect in 2018. Implementation of the expected loss model will require considerable effort, particularly in jurisdictions where the banking system is suspected of harbouring a lot of problem loans. In these jurisdictions, which can be found in both the developed and emerging part of the world, proper implementation of IFRS 9 could be a huge challenge for auditors, market and prudential regulators. Yet IFRS 9 removes the excuses to avoid booking loan losses on a timely basis. It gives auditors and regulators a platform to support consistent application of the expected loss model

around the world. Expect to hear a lot of complaints, but stand resolute in your determination to do the right thing!

Audit

This brings me to my second topic: audit. In the area of audit we have also witnessed significant progress. In Europe, the regulatory framework of audit has been strengthened. It is important that a Committee of European Auditing Oversight Bodies (CEAOB) will be established; like ESMA, this body can contribute to strengthening the quality of audit oversight in the European Union. It is also important that all European oversight bodies will now be completely independent. I believe Portuguese authorities made the right decision in providing the CMVM with the task of audit supervision, since it is a natural complement to supervision of the securities market.

It is important to realise that independent supervision of the audit profession is still a very recent phenomenon in most jurisdictions. It would therefore not have been realistic to expect dramatic improvements of audit quality in the short run. Nevertheless, the first signs of improvements are there. In its most recent survey among its 51 members, the International Forum of International Audit Regulators (IFIAR), for the first time signalled a reduction in the number of unsatisfactory findings, albeit at still too high a level.

The audit profession itself has also developed initiatives. I believe the New Audit Report, which has been developed by the International Auditing and Assurance Standards Board (IAASB) and which will take effect in December, will be a big improvement. The reporting of Key Audit Matters (which some jurisdictions have already gained experience with) is an excellent vehicle for drawing more attention to matters with the greatest risk of material misstatement. As you know, accounting is full of judgement and estimates. The Key Audit Matters can help audit committees and investors focus on areas of reporting which are most affected by subjectivity, such as valuations.

The New Audit Report will be a good instrument for the audit committee to strengthen its independent and critical role vis-à-vis management. I believe the role of the audit committee is crucial to improving corporate governance in the capital markets and it still needs significant strengthening.

Bank Capital

Outside the realm of audit and accounting, the main regulatory achievement has been a substantial strengthening of capital buffers in the banking industry. The common equity tier-one ratio across all global systemically important banks has doubled since 2009. Moreover, the spread between regulatory capital requirements and actual capital as measured under IFRS Standards has narrowed considerably. Just before the crisis, regulatory capital was often four to five times higher than the

IFRS-reported actual capital buffers, thus masking the extreme leverage in the banking system. Currently, the average risk-based capital tier-one ratio is just over twice as large as tangible capital, as measured under IFRS Standards.

Despite this very significant improvement, it remains remarkable that banks are able to report higher capital levels than really exist, as Federal Deposit Insurance Corporation Chairman Thomas Hoenig recently remarked[1] (see appendix A). Also, the reporting requirements for regulatory capital contain fewer elements of discipline than regular accounting. Compared to IFRS Standards, there is less comparability of regulatory capital reporting, since there is local variation in the adoption of the Basel capital rules, especially in Europe. There are also big differences in implementation, as there is a choice between three different risk-weighting methodologies. The Basel Committee is aware of these issues and is considering methods to tackle them.

Leverage in the global economy

While leverage in the banking system has been reduced, the same cannot be said about the global economy as a whole. Quite the opposite has happened.

The 2008 crisis was a classical credit crisis, caused by a build-up of excessive leverage in the economy. In the past, the bursting of credit bubbles usually led to a period of sustained deleveraging. This time, things are really different. Indeed, as a recent publication by McKinsey[2] shows (see illustration in appendix B), the build-up of leverage in the global economy has continued almost unabated.

In 2007, combined global debt of households, corporates, governments and the financial industry already stood at no less than 269 per cent of global GDP. While this staggering number was already historically unprecedented, it continued to grow after 2008. Some deleveraging took place in some categories in some jurisdictions, but on a global scale total public and private debt continued to rise to 286 per cent of global GDP at the end of 2014. Public debt grew especially fast; it ballooned from 33per cent in 2007 to 58 per cent of global GDP in 2014. It is important to realise that the McKinsey leverage numbers do not include the very sizeable unfunded or underfunded pension liabilities of governments. According to recent research by Citigroup[3], these would for 20 OECD Countries alone amount to no less than $78 trillion. These numbers would probably bring the overall indebtedness in the global economy to over 400 per cent of global GDP! It is hard to imagine how all these staggering obligations are going to be met in an orderly fashion.

[1] Thomas M. Hoenig, A Capital Conflict, Paris, 23 May 2016
[2] McKinsey Global Institute: *Debt and (not much) deleveraging*, 2015
[3] Citigroup: Citi GPS: *The Coming Pensions Crisis,* March 2016

Why is it that this time we did not see the deleveraging that usually follows the bursting of a credit bubble? Some of the growing indebtedness, especially of the public sector, was a direct consequence of the post-Lehman recession, which caused budget deficits to rise autonomously. Also, the bail-outs of banks proved a huge fiscal burden in some jurisdictions.

But the most important reason for deleveraging not to occur was intentional policymaking. Policymakers were determined not to repeat history. In an effort to avert a Great Depression, central bankers and politicians around the world pulled out all the stops. In 2008, the G20 and the International Monetary Fund (IMF) encouraged governments around the world to engage in fiscal stimulation. Many Central Banks engaged in quantitative easing in an effort to stimulate credit extension. Interest rates, already on the decline as a result of low productivity growth, were brought down to historically unprecedented levels and they have now even become negative in some jurisdictions.

These policies were successful in that a Great Depression was indeed averted. The global economy was pulled back from the brink and calm was restored to the markets. But this success came with a big price tag in terms of leverage. The rise in public debt became quickly unsustainable in some jurisdictions, causing markets to react.

Before the credit crisis, excessive leverage was mainly confined to the industrialised world. After 2008, leverage increased rapidly also in the emerging markets, both as a result of intentional policies and through spillage of liquidity from the industrialised world. In the short run, this was helpful towards sustaining demand in the global economy. But overall indebtedness is now thought to be dangerously high in several emerging economies.

Unconventional monetary policies also came with a price-tag. The Bank of Central Banks, the Bank of International Settlements (BIS), has warned on several occasions against the negative side effects of ultra-low interest rates[4]. First of all, low interest rates are an incentive for leverage, which is part of the problem to begin with. Close-to-zero interest rates postpone adjustment in both the private and the public sectors. In the private sector, economic resources are misallocated by keeping zombie companies afloat. In the public sector, adjustments to unsustainable public finances are easier to postpone as long as the monetary music keeps playing.

Secondly, current monetary policies lead to asset price inflation. This is partly an intended effect, but one may ask if it is sensible that in many jurisdictions prices of residential properties are now higher than just before 2008. For example, average house prices in London are now 50 per cent higher than their 2007 peak. To be in bubble territory again so soon after one of the worst credit crunches in history defies common sense.

[4] See for example the 82nd annual report of the BIS

Thirdly, unconventional monetary policies are starting to put pressure on the business models of banks, insurance companies and pension funds. The flattening yield curve undercuts the interest margin of banks and increases the liabilities of pension funds and insurance companies. IFRS figures already show the pension liability of many companies going through the roof. Our upcoming insurance contracts Standard will also clearly show the increasing strain on the insurance industry.

Last, but certainly not least, Central Banks should not underestimate the effect of unconventional policies on the public perception of their work. To most people, negative interest rates do not make sense. When policies become so unconventional that they are no longer understood, we are treading dangerous waters.

In uncharted waters

Finally, unconventional monetary policies and a historically unprecedented level of leverage have brought the global economy into completely uncharted waters. Never before have unconventional policies been pursued for so long. Nobody can know how it will end. As Jaime Caruana, General Manager of the Bank for International Settlements, recently put it: 'At this stage, we don't fully understand the implications of low, or even negative, rates for the financial system and the economy as a whole'.[5] Given the enormous uncertainties in macro-economics, one of the most important principles of economic policymakers should be the golden rule in medicine: 'Do no harm'. Can we be sure we do no harm if we do not really know the consequences of these policies?

There can be no doubt that the uncertainty about the sustainability of macro-economic policies and the enormous debt overhang weighs heavily on the global economy. If the 2008 crisis was caused by excessive leverage, what should investors expect in a global economy that is even more leveraged? Even if the banks are better capitalised, are they, or indeed the governments that stand behind them, strong enough to cope with an economic environment that is so loaded with debt? In these circumstances you cannot blame companies for being too scared to make long-term investments.

Finding the way back to normality is so fraught with difficulties, that some advocate the use of even more unorthodox policies. The McKinsey report suggests that it may be necessary to keep government bonds on the balance sheets of Central Banks indefinitely. In some parts of the world this already seems to be happening. Others suggest breaking the taboo around helicopter money.

As a former politician I can only say that, once these taboos are broken, politicians will find it even more difficult to take responsibility for the painful measures that are needed. The unenviable predicament of politicians in these difficult times was recently neatly summarised by Jean-Claude

[5] BIS Papers no 84, May 2016

Juncker, the President of the European Commission. He said: ‘We all know what to do, we just don't know how to get re-elected after we've done it’.

This brutally honest quip contains a lot of wisdom. The second part of his comment indicates how difficult it is for politicians to take the measures that are needed. But the first part gives more reason for hope.

I think it is true that we all, or at least most of us, know what we need to do. Most of us know that we cannot continue to rely on macro-economic demand management. Most of us know that structural reforms to product and labour markets are needed to revive dynamism in the economy. And isn’t it time that we reduce the enormous fiscal incentives for relying on debt, rather than equity, as a source of finance? Such decisions take grit and determination and are not easy to make in an environment of rising populism. But we cannot keep on relying on unconventional policies forever. We are living on borrowed time and we need to return to normality as soon as possible.

In all circumstances, the CMVM can rest assured it will continue to operate in very interesting times. You will continue to need your wisdom and determination to face the challenging years ahead. I congratulate you once again on your first 25 years and wish you all the best for the future.

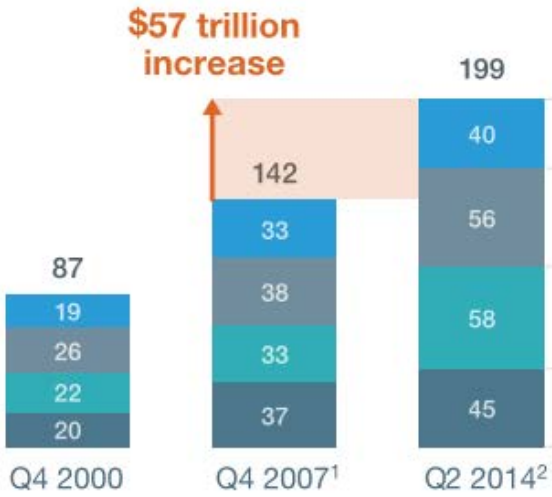
APPENDIX A

	Basel Risk-Based Capital (Percent)	IFRS Tangible Capital Estimate Leverage Ratio (Percent)
U.S. G-SIBs		
Bank of America	11.28	5.78
Bank of New York Mellon	12.29	4.31
Citigroup	14.82	6.57
Goldman Sachs	14.11	5.00
JPMorgan Chase	13.50	5.93
Morgan Stanley	17.37	4.22
State Street	15.33	5.52
Wells Fargo	12.63	8.20
U.S. G-SIBs ($ Total. % Weighted Average)	**13.31**	**5.97**
Non-US G-SIBs		
Agricultural Bank of China Limited (China)	10.96	6.24
Banco Santander (Spain)	12.55	3.24
Bank of China Limited (China)	12.07	7.86
Barclays (UK)	14.69	4.76
BNP Paribas (France)	12.21	3.99
BPCE Group (France)	13.34	4.64
China Construction Bank (China)	13.32	7.65
Crédit Agricle Group (France)	15.29	4.49
Deutsche Bank (Germany)	14.65	3.01
HSBC (UK)	13.90	6.97
Industrial and Commmerical Bank of China (China)	13.48	7.89
ING Bank (Netherlands)	14.45	5.45
Nordea bank (Sweden)	18.50	4.30
Royal Bank of Scotland (UK)	19.10	5.58
Société Générale (France)	14.00	3.73
Standard Chartered (UK)	14.12	6.69
UBS (Switzerland)	10.99	4.10
UniCredit (Italy)	11.50	3.81
Non-US IFRS ($ Total, % Weighted Average)	**13.37**	**5.68**

Source: Thomas M. Hoenig, *A Capital Conflict*, Paris, 23 May 2016

APPENDIX B

Global stock of debt outstanding,
$ trillion, constant 2013 exchange rates



				Compound annual growth rate, %	
				2000–07	2007–14[2]
		199	**Total**	**7.3**	**5.3**
		40	Household	8.5	2.8
		56	Corporate	5.7	5.9
		58	Government	5.8	9.3
		45	Financial	9.4	2.9
246%	**269%**	**286%**	Total debt as a share of GDP		

Source: McKinsey Global Institute: *Debt and (not much) deleveraging*, 2015