Christian Noyer: A new regulatory framework for a new financial system

Speech by Mr Christian Noyer, Governor of the Bank of France, at a round table discussion at the University of Paris-Dauphine, Paris, 11 December 2008.

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Ladies and Gentlemen,

It is a great pleasure for me to take part in this round table discussion.

Today, the prevailing view is – and justly so – that it is necessary to rethink financial regulation. There are two reasons for this:

a) Financial markets and banks are, more or less strongly, confronted with problems of asymmetric information;

b) Operational inefficiencies may arise, leading, in some extreme cases, to the seizing up of certain market segments. Needless to say that these imperfections are interconnected.

In many respects, the financial crisis is the expression of these imperfections. Three examples can be used as an illustration. The underestimation of risk and the mispricing of assets during the upswing of the financial cycle show that markets may generate excess investment in certain sectors of the economy (e.g. the US real estate sector). Furthermore, it appears that financial innovation and the change in banks' economic models have resulted in a significant increase in information asymmetries and, more importantly, in lower incentives for economic agents to pay attention to these asymmetries. Lastly, the fact that some market segments seized up during the crisis suggests that some infrastructures necessary for their functioning are lacking.

To simplify, I believe that the logic underlying the current regulatory system consists in ensuring the financial stability of market segments, but without adopting an overall approach. However, the crisis has forced us to acknowledge that this fragmented approach to regulation does not necessarily ensure the stability of the entire financial system. During this crisis, the fact that financial institutions had considerably increased their use of leverage and that risk was concentrated among a relatively small number of banks was neither well assessed, nor well captured, nor prevented by regulation. In view of this failure and in order to mitigate the impact in terms of financial instability, government interventions were designed, not to stabilize the situation of any particular institution, but to prevent systemic risk from materialising. As a result, we now require macro-prudential regulation.

This naturally leads us to address the issue of the scope of financial regulation. Who should be regulated? The problem is not new; it is also complex. Like me, you will have noticed that, at their last summit meeting, the G20 Heads of State and Government laid down a clear principle on the matter. They have indeed committed themselves to ensuring that "all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances".

The crisis shows quite clearly that the markets and institutions that have a systemic role must be regulated. This criterion implies re-examining the functioning of certain OTC markets, such as the interbank money market or the credit derivatives market. Similarly, rating agencies should also be regulated, given the key role they play in correcting information asymmetries on financial markets. Lastly, public authorities should pay greater attention to those financial institutions that are central to the supply of market liquidity and financing.

An important starting point is to acknowledge that financial system participants have very different functions, pursue different strategies and operate according to different economic models. This diversity is crucial to the smooth functioning of markets. A one-size-fits-all regulatory framework applied to all participants would certainly give rise to herd behaviour and, consequently, reinforce the endogeneity of certain risks.

A gradation could reasonably be applied to the regulations and requirements imposed on financial system participants. Three levels, ranging from oversight to regulation, naturally come to mind. The first level would take the form of a mandatory registration and the commitment to comply with a code of good practices. The second – more restrictive – level would include disclosure obligations with regard to activities and accounts, in addition to the mandatory registration and the compliance with good practices. Hedge funds and, more generally, institutions pursuing strategies essentially based on leverage or risk-taking could have to meet such requirements. Finally, the last level would involve more restrictive regulations with regard to activities and risk-taking, as well as closer oversight.

In many respects, this gradation system is not only relevant with regard to prudential requirements. It should also apply to accounting rules for example. Beyond the theoretical considerations, it is important that financial regulation, in all its forms, should contribute to maintaining financial system diversity. Thus, attempting to measure all assets and liabilities at fair value has some drawbacks – and even entails risks – that need to be taken into account if lessons are to be drawn from the financial crisis for accounting rules.

To conclude, I would like to stress an important point regarding the new financial regulatory framework. It would be unrealistic to believe that financial regulation is the answer, and, above all, that it is capable of protecting us from the risk of financial instability. Indeed, the crisis can largely be attributed to financial institutions' inadequate risk management, which stems from an irrational trust in quantitative tools.

Financial regulation should be an incentive for financial system participants to develop a sound and efficient management framework. It is no substitute.