Christian Noyer: Publication of Bank of France's Financial Stability Review "The future of financial regulation"

Remarks by Mr Christian Noyer, Governor of the Bank of France, at the publication of Bank of France's Financial Stability Review "The future of financial regulation", London, 4 September 2009.

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It's a pleasure to welcome you here, in London, on the eve of a very important G20 Ministerial meeting and to introduce the latest issue of our Financial Stability Review. It is also a privilege to have such a distinguished panel for this introduction and I want to express my gratitude to all.

The Review is about the Future of Financial Regulation. Our hope was to help and contribute to the international discussions and the publication of this Review could not be timelier.

The financial crisis has taught us some very hard lessons. While there are many causes to the crisis, including, maybe, macro economic policies, it is also clear that it forces us to reconsider the way we regulate and supervise the financial system. That is what we are doing, and this will take a significant part in tomorrow's discussions between G20 Ministers and Central Bank Governors. At stake is the scope of financial regulation, its nature, and its objectives.

The scope of financial regulation

We entered this crisis with many unregulated entities playing a major role in the financial system. So, from a supervisory perspective, they were huge "black holes", including what has been called a "shadow banking system" where most of the excesses of securitisation took place.

Not any more. During the last twelve months, a coordinated effort by industrialized and emerging countries alike has brought most important financial actors under the umbrella of supervision. Principles and rules have been enacted for rating agencies to deal with their conflicts of interest, enhance their rating process, increase transparency and their oversight through compulsory registration. Hedge funds will go through a process of licensing and oversight: they will have to meet transparency requirements towards both investors and regulators. Finally, off balance sheet activities will be consolidated and disciplined through changes in the accounting and prudential frameworks.

The nature of financial regulation and supervision is changing.

Here, I see two major trends.

We must **complement *micro*-supervision with *macro*-financial supervision**, taking into account the systemic importance and interconnectedness of institutions, markets, instruments and the cumulative risks and dynamics which they create. System-wide phenomena that went unchecked, such as the aggregate rise in leverage and maturity transformation, must no longer escape our vigilance.

All countries are moving in that direction. In Europe, following the *de Larosière* report, we are creating a European Systemic Risk Board. In the United States, it has been proposed that the Federal Reserve will become the future systemic supervisor. In France, the Government has decided a reform where insurance and banking supervision will be merged under the umbrella of a "systemic" college under the auspices of the Banque de France. Clearly, the move towards macro financial supervision means that Central Banks will have to assume additional responsibilities. History tells us that the missions of Central Banks have taken major turns following financial crises.

Second, regulation will become more **global**. Emerging market economies might feel that they are not part of the problem since they did not play a role in starting the crisis; but they are major actors and are part of the solution. Henrique Mereilles sitting at the table next to me is truly a sign of times, a sign clearly underlined by the increasing role of G2O and the recent expansion of the FSB.

International standards in the field of prudential rules have already paved the way for an international level playing field. I strongly hope that Basel II can soon become a truly universal standard and framework for banking supervision. Beyond prudential rules, it is of the utmost importance that convergence be achieved in accounting standards if only for level playing field reasons. Finally, improved coordination between supervisors through supervisory colleges for all systemic actors (not just banks) will be a significant progress.

The objectives of financial regulation have shifted.

It remains important to increase the resilience of the financial system. We need to ensure that intermediaries build, over time, stronger capital and liquidity cushions, especially for trading activities. The Basel committee has been very active and currently is devising proposals.

But our main priority is to reduce procyclicality in our financial systems. Stronger capital and liquidity cushions must be built in good times and drawn down in bad times. The essential contribution however will come from a change in our provisioning rules. The objective is to build automatic and "through the cycle" stabilizers in a transparent way and according to a rule based system. I believe there is a lot to learn from the Spanish dynamic provisioning approach.

Finally, nothing will work if we do not address the **issue of incentives**. In a market based economy, incentives determine the behaviours of agents. Regulators must aim at creating an environment that is conducive to both efficiency and stability and that can avoid excessive risk taking.

This is why compensation practices are so important. They should be structured so as to induce appropriate risk behaviour and encourage "true" financial innovation. Competition between financial institutions in hiring staff creates a coordination problem and leads to many excesses, acknowledged by the institutions themselves. Compensation policies should therefore be guided by clear and internationally agreed rules covering: (i) the involvement of senior management in traders' compensation policies, (ii) detailed disclosure requirements, (iii) clear and direct links between the payment of bonuses and the longer term profitability of institutions, i.e. that a significant proportion of these payments should be deferred over time, allowing for possible reductions in case losses materialize. This is an area, more than in any other where "business as usual" cannot apply anymore. Considering, especially, recent profits, it is clear that they would not have been possible without the wide array of public support and guarantees which have benefited the financial industry. It is only legitimate to ask that those profits should primarily be used to bolster capital and allow banks to focus on their core task of financing the economy.

Tomorrow's meeting will be an opportunity to ascertain that we have made a lot of progress but that much work remains to be done. It is an ongoing process, best described as "rebuilding the plane as we fly it", clearly a very challenging and perilous task.