Christian Noyer: Beyond Pittsburgh – the future of financial regulation

Keynote address by Mr Christian Noyer, Governor of the Bank of France, at the Paris Europlace International Financial Forum, Singapore, 26 October 2009.

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Ladies and Gentlemen,

I am delighted to address this distinguished audience at the Paris Europlace forum in Singapore. I will take this opportunity to present my analyses on the lessons learned from the crisis regarding the essential reforms in financial regulation.

Since the crisis started, in August 2007, we have gone through the most difficult years in our modern financial history. We have mobilized enormous resources to ensure the survival of the financial system and preserve its integrity. We have implemented exceptional measures, both on the fiscal and monetary front.

We have acted in permanent cooperation between all countries, industrialized and emerging alike. That spirit of cooperation was on full display during the G20 Summit that took place recently in Pittsburgh. The cohesion shown by G20 members has powerfully contributed to restoring confidence.

Today, we can be reasonably assured that we have stabilized our economies and avoided the worst. Current forecasts by the IMF show reasonable prospects for growth in the world economy in 2010. But there are many downside risks and adverse scenarios that could still materialize. Above all, we have a duty, and a mandate, to make sure that the causes of the crisis are addressed and that our economies do not fall victim to such shocks in the future.

Reforming and adapting financial regulation remains an urgent priority. G20 Leaders have agreed on detailed principles and a roadmap. The newly formed Financial Stability Board has the difficult task of steering regulatory reform. We are very fortunate that the FSB, as well as the Basel Committee, has been enlarged and become a true reflection of the world economy. As you may know, the European Union is moving towards the creation of a new European Systemic Risk Board (ESRB) which will be responsible for macro-financial supervision and will draw extensively on the resources and expertise of the Eurosystem. In France, the Government has decided to create a single authority responsible both for banking and insurance supervision, with very close links to the Central Bank. This will enable us to look at the state of and developments in the financial system from a truly systemic perspective.

Much remains to be done. Let me outline the main objectives. In the current circumstances we should (1) try and keep up the momentum in the pursuit of reforms, (2) achieve balance in the implementation of the agenda; and, (3) ensure consistency between our regulatory actions and macroeconomic policy.

Keeping up the momentum

Over the last few weeks, major international banks have announced impressive quarterly profits. It is striking that these performances were achieved only a few months after some of those same institutions came very close to failure. This might give the impression that the financial sector has recovered its balance and that no further reforms are necessary. Nothing could be further from the truth. Indeed, one major risk in the period to come is the emergence of a "business as usual" mentality. Once the immediate dangers have receded, the incentives to reform may become weaker and the opposition stronger. It is essential that we keep up the momentum.

First, it is clear to everyone that recent profits in the financial sector, while welcome, are, for the most part, a result of public policies implemented to combat the crisis. They would have not been possible without the low interest rates which currently prevail and the public guarantees still in place.

Second, there are signs that parts of the financial industry have resumed risk taking practices reminiscent of those which led to the crisis. This impression may be reinforced by compensation packages which, although formally compatible with G20 agreed rules and principles, may appear out of line with the underlying performance of the industry. At the same time, bank credit to the business sector is faltering, especially for small and medium-sized companies, and most of the negative effects of the economic downturn on balance sheets are still to come.

It is therefore crucial that we keep focused on our long term goals. Our economies need more robust and better capitalized banks. They need greater transparency and regulation of non-bank financial entities. They need more countercyclical prudential and accounting rules. They need sound infrastructures for clearing and settling credit derivatives, in order to minimize systemic risk. They need stronger and robust risk management and better governance in all parts of the financial industry. They need increased oversight and stronger supervision of systematically important institutions.

As a result of the crisis, the financial system will be permanently changed. Reforms will make it possible to increase its efficiency and, at the same time, improve its stability. This will be achieved through stronger international cooperation. It is very significant that the leaders announced in Pittsburgh that Basel II will soon become a truly international standard and, at the same time, it will be reformed and adapted to take on board the lessons of the crisis.

Striking a balance

The regulatory agenda is comprehensive and complex. It has been thoroughly debated. It has to be taken as a whole and cannot be implemented in a piecemeal fashion; otherwise we would recreate distortions and new possibilities of regulatory arbitrage.

Let me give you two examples.

First, on procyclicality. It is widely recognized that, in the past, prudential and accounting regimes have increased the procyclicality of financial systems, especially in boom periods, by encouraging excessive risk taking. Accordingly, reforms are being considered both in the capital and accounting frameworks. As a consequence of decisions taken by the G20 and the FSB, countercyclical capital requirements will be implemented by the Basel Committee and accounting standard setters have been asked to put in place a countercyclical provisioning regime. While respecting the independence of standard setters, it is very important that these two efforts progress in parallel. It is the combination of accounting and prudential rules which shape the incentives of investors and managers. Partial reform, limited to the prudential field for instance, will not suffice and could even introduce additional distortions. The Basel Committee has come out with a comprehensive approach to capital and accounting reform to reduce procyclicality, embodied, in particular, in the Principles for revision of IAS 39 (“Financial Instruments: Recognition and Measurement”). It should be strongly supported.

Second, on leverage. Excessive leverage has been a major cause of the crisis. In many instances, it could not be detected early enough, because attention was focused on risk-weighted measures of capital utilisation. There is great merit, therefore, in introducing a leverage ratio as an essential tool of macro-prudential supervision. It is also envisaged as part of the capital requirement regime as a complement and "backstop" to risk-weighted measures.

It may be almost impossible, however, to use it as a binding instrument on an international basis. The reason is simple: while it is relatively easy to measure the evolution of the leverage ratio over time for an institution or group of institutions, it is almost unfeasible to measure it consistently across countries, due to differences in accounting regimes and banking structures. An enormous amount of work is therefore necessary before integration of a leverage ratio into the Basel framework can be implemented. In particular, full convergence in accounting measurements of both assets and capital is an absolute prerequisite. Any attempt to short-cut this process and build up ad hoc measures for purely prudential purposes will not succeed. It runs the risk of adding significant distortions and having unwanted consequences. In particular, if not carefully drafted, the leverage ratio could create incentives for banks to pile up riskier assets in their balance sheets, in order to maintain the same returns on equity with lower leverage. This would only aggravate the problems that regulation is trying to solve and precipitate the next crisis. This is why some scepticism is warranted as to the possibility of using the leverage ratio as a universally binding, or in the language of regulators, a "pillar one" component of the capital framework.

Consistency with macroeconomic policy

Regulatory reform has today to be implemented in a very uncertain macroeconomic environment. It is therefore important that we strike the right balance: efforts towards long term reform must not create, in the short run, additional downside risks to economic activity. Since Pittsburgh, we have a roadmap and we have deadlines. We must find the optimal sequencing to reconcile our ultimate objectives with the need not to impede the recovery.

This is especially relevant for the capital regime. Banks must have a much stronger capital base in the long run. But, in the short run, we expect credit to continue flowing to the economy and we want, therefore, to avoid any abrupt and disorderly deleveraging. We don't want, in short, the introduction of a new capital regime to have a procyclical effect on our economies. In the euro area, the economy depends on the banking system for more than two-thirds of its financing. Any lasting disruption to credit flows would cause considerable harm.

Regulators could jointly decide on the following sequence. In the immediate future, priority should be given to capital conservation. As I mentioned, most of the current banking profits are, in fact, by-products of public policies and there is a good case for requesting that they should be kept inside the banking system and used to strengthen balance sheets and finance credit to the economy. This would require some restraint in dividend distribution and, of course, in the overall amount of variable compensation. In parallel, all possibilities to issue new equity should be exploited. This would be a first step.

As a second step, a progressive schedule of capital strengthening could be precisely defined and published for the future. It would be crucial that this schedule be made explicitly contingent on the state of the world economy. Again, we want the direction and the path to be clear. But it is important to avoid any negative procyclical effects. The same approach could apply to the new liquidity regime when it is introduced.

Let me conclude by mentioning one broader and fundamental issue. We don't know yet what kind of financial system will emerge from the crisis. We need to think about this. We want to reduce or eliminate moral hazard, but the definition of a systemic institution still eludes us. As a result of the turmoil, and of the policies implemented to contain it, some financial activities have become heavily concentrated among a very small numbers of players. This raises some basic questions about monopolistic tendencies. Competition policy in the financial sector must be reinvented. This cannot be done without some vision about the future shape and structure of the financial industry, as well as the degree and modalities of its internationalisation. The debate is clearly open. This is – for all G20 policy-makers, the FSB and regulators – a formidable challenge.