Christian Noyer: Financial stability in Europe and in the world – a French perspective

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the Open podium debate on "The euro in the financial crisis – lessons and perspectives", Copenhagen, 22 March 2010.

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It is a great pleasure to be here in Copenhagen at the gate of the euro area. This makes it all the more stimulating to discuss here with you issues related to the single currency, the financial crisis and the emerging new financial order. It allows for sharing experience and perspectives, which in and of itself is valuable for policy-makers.

I would like to focus my remarks more on the emerging new financial order. More specifically, in the few minutes I have, I would like to share with you some thoughts, in a candid way, on three important policy questions.

How can we make our financial systems more resilient?

How can we reduce the procyclicality of financial systems?

How can we best address systemic risk?

Resilience

Central banks have a strong stake in the resilience of financial systems. An environment of financial stability reduces the risk that monetary policy instruments become less efficient due to frictions and volatility in financial markets.

Strong prudential standards are a certainly a prerequisite. It is now apparent that the level and quality of pre crisis capital in the banking system has not been adequate for the types of losses that have been experienced and that are expected to materialize from the broader economic downturn. Larger capital and liquidity buffers are necessary especially for trading activities.

In the Basel framework we have recently taken decisions which will lead to a much more robust and resilient banking system in the future, with both a stronger capital and liquidity base. The challenge, now, is to calibrate and phase in the new framework in a way that does not impede the recovery and does not contradict our macroeconomic objectives. In the long run, we want stronger balance sheets in the banking system. In the immediate future, disorderly deleveraging is one of the main downside risks to the recovery process. Striking the right balance, in our actions and in our communication, is important, but difficult. The top-down assessment underway in the context of the Basel committee and the FSB is trying to reach that balance. The broader point here is that the proposed reforms can have significant macroeconomic consequences and these should be factored in when designing and implementing them. While the crisis has clearly had global ramifications, its impact on financial systems was not uniform across the world. Differences in financial structures do matter. Banks remain central in our financial systems: this is especially true for continental Europe where they are responsible for more than 80% of financial intermediation. These differences suggest that we should be careful in crafting the regulatory answer to the crisis. Our experience in France is that our banks' universal model has weathered the storm relatively well. It would be a major paradox to put in place rules which would challenge such universal models. There needs to be scope for different countries to tailor solutions to their circumstances, while at the same time doing so within a globally agreed framework.

Many banks have improved significantly their capital position through raising high quality capital. Yet, banks may not feel comfortable if their new capital position is barely above the new minimum. Indeed, a critical issue going forward relates to the behavior of banks with respect to capital buffers they retain on top of the existing minimum. If banks target buffers above the regulatory minimum, which is an endogenous market outcome, they may need to raise even larger amount of equity than what can be expected just looking at the current package. On the one hand we know from empirical studies that weaker capitalized banks typically exhibit weak loan growth compared to other better-capitalized banks. On the other, banks may find it less costly to adjust loan volumes and loan pricing than capital, as frictions in the market for bank capital make the latter option more expensive.

Finally, any regulatory framework needs to manage avoidance and regulatory arbitrage, and keep up with innovation and other forms of structural change. For this, a necessary, but not sufficient condition is that standards are comprehensive in coverage and consistent across jurisdictions. I am not sure, for instance, that the leverage ratio, if it was to be implemented as a compulsory instrument, would meet this double test. At the current level of accounting divergences, consistency will be very difficult to achieve. Furthermore, there is a risk that it would encourage migration of credit activities towards other – less regulated – parts of the financial system.

It is therefore important that consistency apply across standards and countries. Convergence between accounting standards is a precondition for a consistent implementation of some of the prudential reforms discussed by the Basel Committee. It is also essential that new prudential standards for banks become truly universal.

Procyclicality

Strictly speaking, procyclicality is a tendency of financial systems to fluctuate around a trend with the economic cycle.

By extension, procyclicality can encompass all "amplification mechanisms" through which an initial shock results in wider movements in asset prices, credit flows, market liquidity, and, possibly, the real economy.

Our accounting and prudential regimes have increased procyclicality in recent years. In a mark to market environment, asset prices movements quickly translate into changes in the capital base of financial institutions. This, in turn, triggers additional demand for assets and a further increase in their prices. This kind of "inverted demand curve"; where demand increases with prices, may create the conditions for deep and lasting financial instability. Addressing procyclicality caused by the regulation itself is therefore a priority.

The first line of defense against procyclicality should be the accounting framework. I strongly support the current focus on changing the accounting rules. More precisely, moving from an incurred loss model to a forward looking model is essential. We need a robust, auditable and straightforward provisioning system at the accounting level based on a forward looking model that would allow provisioning efforts commensurate with credit risks through time. This framework should also be simple, bearing in mind the ultimate objective of creating synergies between prudential and accounting standards.

The Basel Committee is working on a very comprehensive approach, which is casted in its "Principles for revision of IAS 39". Accounting standard setters have also been working hard. I firmly believe that two steps are required going forward. One is that the IASB should follow the principles by the Basel Committee. Another is that the IASB and the FASB should adopt a common methodology regarding provisioning based on expected credit losses. This is a precondition to ensure that the G20 countries have convergent accounting systems.

Some of the procyclicality can also be trimmed through prudential regulation. Efforts to make solvency ratios potentially less procyclical are welcome and should be pursued. In particular those efforts aimed at imposing a measure of risks "through the cycle" or "downturn" are useful. Other options to take some of the procyclicality off through prudential standards include a fixed buffer, which would act as a capital conservation device. I see some limitations to such an option. It is hard to see how this fixed buffer, supposed to be on top of the minimum requirement, would not be perceived as a new regulatory minimum. Also, it is very hard to see how this mechanism may not have adverse impact on banks' share ownership. Another avenue to address procyclicality through prudential rules is by putting in place a countercyclical capital buffer. The logic is simple and, in principle, appealing: the mechanism, indexed on a macroeconomic variable, would force banks to build capital reserves when they can do so and allow them to consume such reserves in a downturn. This would be expected to ensure that banks accumulate and use self-insurance in synchronization with the financial cycle. In practice, we still need to clarify the conditions and the set up for triggering the release of surplus capital accumulated through the mechanism. Such a mechanism may not necessarily be cumulative with others and we may have to choose.

Systemic risk and moral hazard

As techniques for managing and allocating risk became more sophisticated, the network of counterparties expanded in scale and in complexity. This was, truly, a systemic change that was properly understood but not fully captured by regulators at the time. Credit and market risk was supposedly more broadly spread. But counterparty risk increased. Overall, the overall impact on financial stability may well have been negative.

There might be a temptation to assess systemic risk through a crude "size" criterion. "Too big to fail" certainly warrants special treatment. But, the position and role of even smaller or medium size actors may also put them in a situation to have a strong influence on the system's dynamics. There is a need to account for other dimensions of systemic importance such as interconnection, complexity, substitutability. Furthermore, the "systemic" character strongly depends on circumstances, the environment and the specific features of the financial system. Drawing up an a priori list of systemically important institutions would give a false sense of certainty. It may also fuel the moral hazard associated with such firms being perceived by markets as – exactly that – systemic.

Various initiatives are currently discussed, including stronger cooperation between supervisors and, more controversially, additional capital charges. They certainly require further thorough analysis It is essential to avoid threshold effects and never forget that risks are continuous in nature, time-varying and state-contingent.

The debate about systemic firms echoes also concerns about the activities and business models of some institutions. It is especially so in countries where public intervention to rescue the financial system was on a massive scale. The presumption is that smaller and leaner financial institutions would pose less risk to financial and macroeconomic stability than larger and more diversified ones. Yet, facts suggest this cannot hold as a general lesson from the crisis. Indeed, those banks which suffered most from the crisis were precisely those which were more specialized, such as the investment banks. By contrast, large universal banks, reliant on a large deposit base, could withstand the shocks comparatively better.

To deal with systemic risks, there is a lot of merit in investigating more what I would call "market options". Financial innovation can bring an essential contribution to growth and prosperity. It can also create significant instability. To reap the benefits of innovation and reduce its risks, we need robust and resilient financial systems and infrastructures.

In this respect, concentrating systemic risks in central clearing counterparties for the most important markets (interbank, derivatives) may bring us a long way in reducing them. Even in CCPs, counterparty risk never disappears. Clearing houses concentrate the risks and remain vulnerable to a default by a major participant. They should operate under appropriate oversight in order to ensure that they are properly capitalized; maintain robust risk management practices; and meet high standards of governance. They must also not be dependent on liquidity provision by other financial intermediaries, which means they should have access, at any time, to Central Bank liquidity.

Credit Default Swaps (CDS) are a case in point. The market is very opaque and increasingly concentrated between a small numbers of institutions. Worldwide, five banks – one of which is based in Europe – account for half of the CDS market. Besides, leading CDS players trade primarily among themselves and the actual transfer of risk through CDS has become more limited. Concentration and interconnectedness have increased with financial crisis. They are sources of vulnerability, a risk for the liquidity of the market and a threat to efficient pricing.

The transparency of the CDS market should also be enhanced. Data warehouses, because they hold the register of all positions, are key players in that respect: whatever their location, they should provide supervisors and regulators with access to all the data they need to conduct effective macro- and micro-surveillance. With both a stronger market infrastructure and greater transparency, we will be in a good position to ensure that CDS provide a safer contribution to the financing of the economy.

Most of these remarks have been focused on the major and vital impetus to enhance financial regulation. I cannot conclude without mentioning that changes in financial regulation are not a panacea for strengthening financial systems and ensuring that the new financial order will be less prone to instability. What is also absolutely critical is that macroeconomic policies do not derail financial stability. As I mentioned in my introduction, there is no free lunch in being a member of a monetary union. The credibility of policies for financial stability is contingent upon the conduct of other policies. Disciplined fiscal policy is a precondition to achieve macroeconomic and financial stability.

Looking into the future, a macro-prudential policy framework could provide further rooms for maneuver. In a nutshell, macroprudential policy could alleviate some of the constraints associated with the conduct of monetary policy when faced with asset price instability. It might also alleviate the burden on fiscal policy by limiting systemic risks and thus lowering the need for state financial rescue packages. That said, in practice, developing a well-articulated macroprudential policy framework raises some challenges. I trust the benefits of addressing them are worth the impressive hard work currently underway.

Thank you for you for your attention.