

Christian Noyer: Evolution of the regulation in Europe and in the United States – convergence or divergence?

Keynote address by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, to the Paris-Europlace Financial Forum, New York, 18 April 2011.

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Strengthening financial regulation has been high on the agenda of the G20 since Pittsburgh in October 2008. Much has already been achieved both at the international level especially through the Basel Committee for Banking Supervision but also on national level with the Dodd-Frank Act in the US and the pending regulation for market infrastructures in the European Union.

It is fair to say that the evolution of the regulation in Europe and in the United States has not always followed the same path in the past. At a time when our regulations are completely revisited and when many restructurations are taking place in the finance industry, rigorous consistency on both sides of the Atlantic is clearly needed if we want to avoid regulatory arbitrages and uneven level playing field which would be the seeds for inefficiencies and future disappointments.

In my remarks today, I will briefly discuss the achievements on reforms of financial regulation. Then I will highlight some existing discrepancies between European and US regulatory frameworks that should be addressed.

I. Regarding achievements in financial regulation: What has been completed so far?

Three main issues warrant specific attention:

- First, at the G20 level, the reform on OTC derivatives;
- Second, the Basel Committee work for banks (Basel 3);
- And third, the accounting reforms by the IASB and the FASB.

1.1 One of the most visible regulatory changes is the reform to address weakness in OTC derivatives markets

Although they were not at the origin of the crisis, they certainly and conspicuously aggravated systemic stresses in a weakened global financial system.

The forthcoming European Market Infrastructure Regulation – commonly called “EMIR” – as well as the Dodd Frank Act is both of paramount importance in order to fulfill the Pittsburgh’s commitments made by G-20 leaders. I see as particularly important the increase in transparency, the prevention of systemic risk, the promotion of financial stability.

In order to meet these objectives, both regulations do introduce mandatory reporting of derivative transactions to trade repositories as well as mandatory clearing for eligible standardized transactions.

Both regulations do take into account the fact that a mandatory clearing obligation may also increase the systemic importance of clearing houses. Indeed, both regulations introduce more stringent organizational, managerial and prudential requirements in order to ensure that those clearing houses are safe and sound and comply at all times with those requirements.

The fact that both regulations are overall consistent and support the same objectives is of crucial importance and it is a first achievement for financial stability.

Nevertheless, it is only a first step, and implementation measures have still to be elaborated by European and American competent authorities and, as recalled by a popular saying: as usual “the devil is in the details”.

Therefore, it is of the uttermost importance to further encourage cooperation and exchange of information between the European and American competent authorities. I will come back on this issue later on.

1.2 Concerning the recent evolutions of the banking regulation, let me first point out that, to me, the Basel 3 package constitutes a very significant advance that will in the long run strengthen the prudential framework for banks. The main message I would like to emphasize today is that Basel 3 is a balanced reform, in the sense that it is both ambitious *and* cautious.

The scope of risks captured by the Basel framework has been enhanced very significantly. Banks' capacity to absorb losses has been magnified by more than three times if, beyond the higher level, you account for the improvements in the quality of capital. Some incentives towards excessive risk-taking have been corrected, through higher capital requirements for riskier activities, notably those related to re-securitization, and also through new rules for compensation policies. A leverage ratio will be introduced that will act as a backstop, and not a substitute, to risk-weighted regulation.

Besides, I believe that, with Basel 3, some important work of *harmonization* has already been done. For instance, we now have a far more stringent and more harmonized definition of regulatory capital. The need for common and internationally harmonized capital and liquidity requirements has been broadly recognized and will be made operational in the near term.

Basel 3 represents therefore an ambitious goal. At the same time, it has been set in a cautious way in order not to impact the financing of the economy and the global growth. Those latter points are the reasons for the rather long phasing in, that has been put in place by the Basel Committee. This phasing in period should also enable countries that did not move to Basel 2 – namely the US –, to implement Basel 3 at the same pace than European banks.

As a matter of fact, I consider it essential ***that implementation of this new framework both in Europe and in the US be concomitant – and exhaustive*** and I am far from being the only one. As a matter of fact, experience shows that if a reform is not implemented globally, weaknesses remain. The American administration is very positive and determined about it, so I trust that can be done. Failure to implement Basel 3 in a globally consistent way would lead to a competitive race to the bottom and may thus plant the seeds for another crisis.

1.3 Last but not least, another area in which significant progress has been made since the crisis is the accounting framework.

Following the impetus of the G20 and the Financial Stability Board, there is a current trend in accounting reform for reducing the scope for mark-to-market and for moving from an incurred loss model to a forward looking model of provisioning. In particular, both the IFRS and the US GAAP will include an amortized cost category for financial assets such as loans. In my view, these types of changes in the accounting rules constitute the first, and to my mind the most powerful line of defense to limit the procyclicality brought forward by the crisis.

I also want to point that even we if are witnessing some significant progress between the two sets of accounting standards, I am convinced that further convergence is needed.

II. Indeed, when it comes to the sources of differences and discrepancies between US and European regulation frameworks, I'd like to bring to your attention the following issues:

- Regarding OTC derivatives, further consistency at technical and implementation level is key in order to avoid regulatory arbitrage;
- The convergence between IFRS and US GAAP is particularly needed to allow for a level-playing field implementation of some regulatory requirements, such as a leverage ratio, over different jurisdictions.

2.1 Regarding the *OTC derivatives reform*, there is a great degree of parallelism in the EU and US approaches, but *issues arise as the details are worked out*.

First of all, regulators have been mandated to make important determinations, such as which derivatives may still be traded over the counter or which participants could be granted exemptions in clearing obligations. It is obviously essential that our regulatory efforts result in similar solutions so as to avoid creating arbitrage opportunities.

Second, the scope of possible mutual recognition regimes for trade repositories and clearing houses should be carefully assessed in order to obtain a fair reciprocal treatment. The basic principle is fairly simple: a third country trade repository or clearing house could service participants or markets of other countries provided that the legal and supervisory arrangements are deemed equivalent and that international cooperation arrangements are established. But equivalence is not really easy to assess and one could understand a more conservative approach based on a systematic registration. Indeed, under such a regime, a third country trade repository or clearing house servicing participants or markets of another country would have to be registered by the competent authorities of that country and, once registered, would have to be subject to regulations and to on-site inspections, in addition to the domestic ones.

While, in order to decrease the risk of burdensome and inefficient regulatory overlap, the position held in the European EMIR regulation proposal is to support mutual recognition regimes, registration regimes do remain implemented in other major jurisdictions; in particular, in the US as foreseen in the Dodd Frank Act that applies to activities outside the US that have a “direct and significant connection with activities in, or effect on, commerce of the United States.” In practice this may mean that non-US entities would become subject to the requirement of the DFA, unless an exemption is granted. In my view, the US regulation and the subsequent registration to US authorities should not lead European entities to be subject to a redundant or a double regulation.

The issue of access to the information stored in trade repositories is also particularly sensitive. One can easily understand that if the national supervisory bodies keep both full access to the locally registered TR and full control of the access granted to foreign supervisors, we will rapidly conclude that we need one TR per asset class and per country, which will clearly be sub-optimal from a supervisory point of view, since we need a consolidation of the risks, and from an industrial point of view with an increased cost for everybody.

Hence, it is crucial to continue our common discussions with the American authorities in order to limit redundancies and inconsistencies, of information decrease the risks of regulatory arbitrage or overlaps, whilst our common objective remains the safety and soundness of financial market infrastructures. Constructive dialogue between rule making agencies is essential.

2.2 *In the field of regulatory and accounting standards*, I would like to point out that convergence is highly needed in order to allow users of financial reporting, especially regulators, analysts, and market participants to draw relevant comparisons between banks.

- Firstly, let me say briefly that *the largest European banks have strengthened their robustness during the last two years and are, at least, as robust as their US peers*¹:
 - The top European Banks have seen their revenues increase by 8.6% on average from 2009 to 2010 (up 2.5% for the main US banks over the same

¹ The following figures are based on calculations made with a sample of 17 large European and American banks: JP Morgan, Wells Fargo, Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, HSBC, RBS, Barclays, Santander, BBVA, BNPP, SG, Groupe Crédit Agricole, UBS, Crédit Suisse, Deutsche Bank.

period). All banks have benefited from a decline in their costs of risk (–43% for US banks and –30% for European banks, from 2009 to 2010). But in absolute terms, the cost of risks amounts to EUR 63 bn for the top 4 US banks, as opposed to only EUR 58 bn for the 11 largest European banks.

- Solvency ratios have significantly improved in Europe, banks have retained earnings and increased capital through various ways (new equity issues, dividends paid in new shares);
- With **Tier 1 ratios** comprised between 10% and almost 18% for the main European banks, they are equivalent to the range of 11%–16% of American banks.
- Regarding now the **core Tier 1 ratios**, which is the measure displayed by banks for the markets, they are also pretty equivalent. Again, with ratios ranging between 8.5% and 15.3%, the main European banks are as solid as US banks (with ratios between 8.4% and 13.3%).

– Secondly, **the differences in the leverage ratios levels mainly result from accounting discrepancies** that can lead to particularly misleading comparisons:

- If we observe the **leverage multiples**, it is true that the figures displayed by US banks (between 10% and 14%) are lower than those of most of European banks. For the latter, the range is much wider (between 15% and 25%).
- But we all know that the measurement of the leverage ratios is significantly impacted by different accounting treatments, the main differences between IFRS and US GAAP arising from the netting of derivatives and repos.
- The example of Deutsche Bank is a case in point to illustrate this impact. At the end of 2010, the institution presented total assets of EUR 1,900 bn. But, according to the bank, on an adjusted basis, which reflected netting of derivatives and certain other balance sheet items, total assets were EUR 1,200 bn. In addition, according to some analysts, the grossing-up of derivatives assets alone would create a rise in total assets comprised between 42% and of 129% for the largest US banks.

The discrepancies in the offsetting of transactions have been outlined by the Financial Stability Board. As a result, the two leading accounting Boards have swiftly reacted in putting this topic on their convergence agenda. **I welcome this joint project and wish that the two Boards**, after the consultation period with their respective constituents, **will be able to publish a common standard** that will facilitate the implementation of a global leverage ratio.

2.3 More generally, the differences in accounting standards between IFRS and US GAAPs have been a matter of concern from the beginning of the crisis.

Since April 2009, the G20 has continuously asked the two Boards to converge towards a single set of high quality global accounting standards and to complete their convergence project by 2011 with the aim of remedying the major weaknesses identified during the crisis. The standard setting Boards have made progress, but **standards have still to be finalised and this is not an easy path.**

- Regarding the **impairment of financial assets**, the two boards have eventually agreed on a joint project based on a forward looking model that should allow for the building up of provisions at an earlier stage of the life of the portfolio. It is of the utmost importance to have a converged standard to avoid any accounting arbitrage across the Ocean and to facilitate international comparisons between global banks. A balanced standard should be able to dampen the effects of an economic down turn.

- Concerning the **classification of instruments**, the importance given to the business model of the banks has led to recognize an amortized cost category for a broader range of instruments, and to reconsider the extensive use of fair value in the IFRS standards. Nevertheless, **convergence between the IASB and the FASB is far from being achieved**. Even if the US standard setter has recently set an amortised cost category, the latter would have a narrower scope than in IFRS and the overall architecture of the classification model is not yet finalised.
- The SEC is expected to give its decision on the adoption of IFRS by the end of this year. Definitely, the easiest path to fill in the gap between the IFRS and the US GAAPs would be the adoption of IFRS by the US.

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Let me conclude.

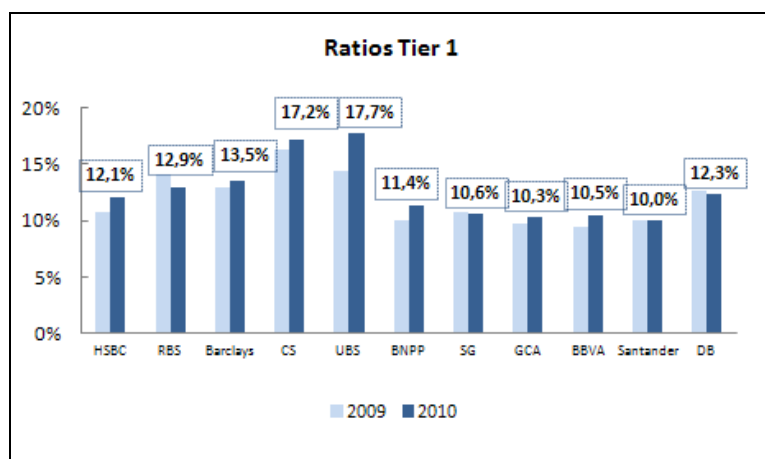
- The various G20 statements set clear directions and deadlines. Looking ahead, our challenge is now to specify the rules and implement them. The main challenge for regulators now lies in finalizing the rules and incentives that will be conducive to reaching these targets. Thanks to the agreement reached by G20 leaders, **ambitious regulatory reforms and markets initiatives are now under way**. I recognize that the regulation of global finance is a considerable challenge: we have to preserve innovation while setting the limits on the capacity of instruments, markets or models to weaken the whole system.
- **Our goal now is to ensure consistency across countries of the detailed regulations while keeping the momentum of the reform**. Indeed, OTC derivatives are a global market, large banks are not local players and accounting standards should be a common language. Any discrepancies in the regulatory frameworks would be easily arbitrated, creating loopholes in the system. In that perspective, **we clearly need to strengthen our coordination**.

Ladies and gentlemen, thank you for your attention.

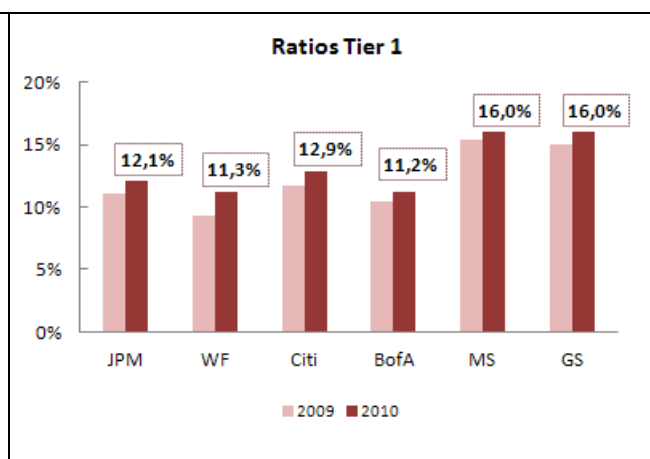
ANNEXES :

1. Niveaux des ratios de solvabilité et de levier des principales banques européennes et américaines

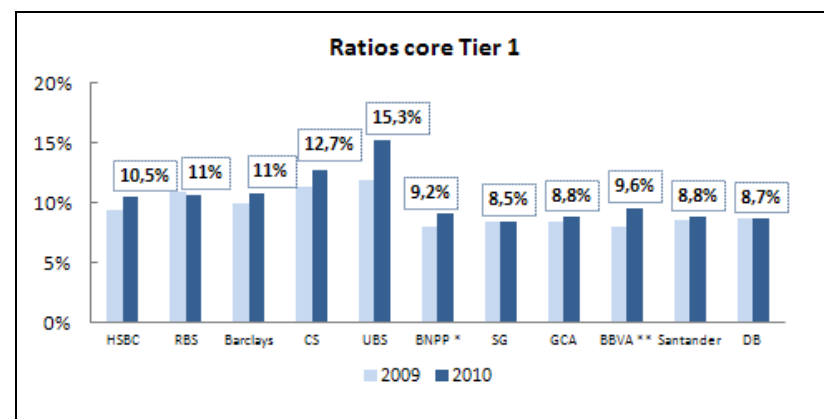
Ratios Tier 1 des principales banques européennes



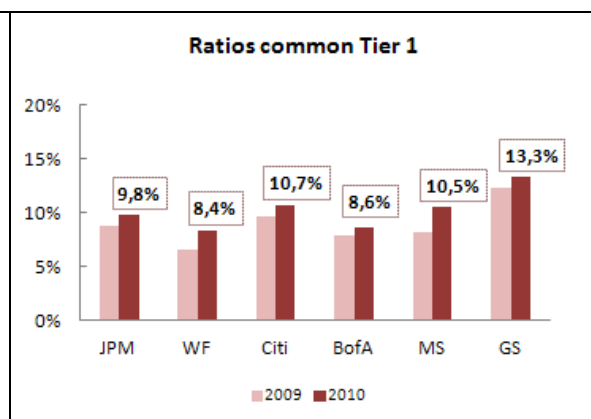
Ratios Tier 1 des principales banques américaines



Ratios core Tier 1 des principales banques européennes



Ratios common Tier 1 des principales banques américaines



Source : Rapports financiers des banques

* Pour BNPP : common Tier 1 ratio

** Pour BBVA : core capital ratio

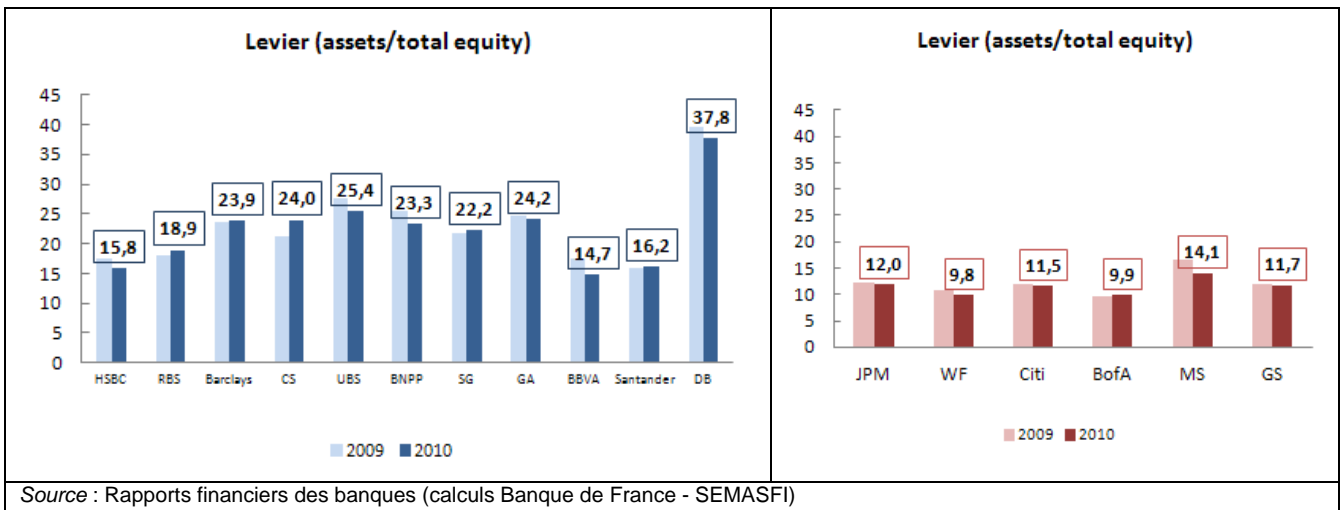
Si le **Tier 1** est défini par la réglementation, le **ratio de fonds propre « core »** ne l'est pas.

Selon les pays et même selon les banques, on parle de core Tier 1 ou de common Tier 1 ou encore de core capital ratio. Ces termes ne recouvrent pas toujours la même définition des fonds propres car il ne s'agit pas d'une mesure réglementaire mais d'un indicateur davantage destiné au marché, sur lequel les banques disposent de plus de liberté pour son calcul et sa communication.

A noter que même le core Tier 1 et le common Tier 1 ne sont pas toujours définis de la même manière par les banques.

Levier des principales banques européennes

Levier des principales banques américaines



2. Impact de la non compensation (*netting*) des opérations sur les dérivés sur le total bilan et les leviers des banques US

Augmentation du total bilan si non compensation des opérations sur dérivés (hors repos)

Impact du *netting* sur les ratios de levier des banques

