Christian Noyer: Banking regulation and the financing of the economy

Introductory speech 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 Forum, New York, 26 April 2010.

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It is a great pleasure for me to be here in New York and address the audience of this Paris-Europlace Forum. As always, the forum is an opportunity for sharing experiences and perspectives. As we make progress in our efforts to strengthen financial regulation, such discussions are very valuable for confronting views and making sure that we are on the right track.

To some extent, the ultimate aim of financial regulation has to do with financing the real economy. Sound regulation should enable the stable provision of financial services to economic agents as they strive to finance their activities. This is why I would like to discuss with you a few aspects of the current reforms of financial regulation that are critical in terms of the financing of the economy.

More precisely, in the few minutes I have, I would like to share with you some thoughts on three important policy challenges.

How can we make our financial systems more resilient and therefore capable of financing the economy on a long term basis?

How can we reduce the procyclicality of financial systems?

How can we address systemic risk?

Before discussing these topics, let me first set the stage and recall why the current focus on enhancing banking regulation is right.

From an economic viewpoint, banks perform two broad functions. They first perform maturity and liquidity transformation. Maturity and liquidity transformation is due to the nature of their assets and liabilities: traditional bank assets are rather illiquid and longer term, whereas their liabilities are more liquid and shorter term. Banks also perform a credit risk screening function, as they should be well-equipped to assess such risks.

As such, banks are central to the financing of economic activity. Economic development requires sound banking systems. Indeed, productive investment and, to some extent, consumption, which constitute the fuel for growth, require financing in order to be carried out. This financing may be obtained through two channels: capital markets or banks. These two channels are complementary. But the role of banks is clearly central. This is especially true in continental Europe, where they are responsible for more than 80% of financial intermediation. Although US firms rely much more on financial markets, banks play a key role here too.

Admittedly, large companies, which are regularly monitored by rating agencies, may “avoid” borrowing through banks, but we know the limitations of extending this aspect of the securitization process, which enables direct market financing, to the financing of small and medium-sized enterprises or households.

Typically, two constraints weight on the supply of credit by banks. The first is a constraint on banks’ capital. Prudential rules, by linking the development of banking loans to the level of banks’ capital and by weighting the loans according to their risks, create a capital constraint that is especially harsh in times of crisis when the weighting increases with the risks and when due to accounting rules, which impose marking to market for certain assets, the capital base is eroded. The second constraint is a liquidity constraint. It is linked to the ability of financial players to access markets to refinance themselves. When banks cannot refinance

their portfolios, they are forced to shed assets and cut back on new credit. The recent crisis has featured the combination of these two constraints.

Let me now turn to the main points I would like to discuss.

How can we make our financial systems more resilient on a long term basis?

It is clear that the level and quality of pre crisis capital in the banking system has not been adequate relative to the types of losses that have been experienced and that may be expected to materialize in a broader economic downturn. Larger capital and liquidity buffers are necessary, especially for trading activities.

The recent reform package of the Basel Committee 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 but too high capital requirements could have negative effects, reducing loan supply and, paradoxically, fostering risk-taking in order to keep a high return on equity. In the immediate future, disorderly deleveraging is one of the main downside risks to the recovery process. A macroeconomic assessment of the reforms is underway and will help us strike the optimal balance. The broader point here is that the proposed reforms may have significant macroeconomic consequences and these should be factored in when designing and implementing them.

A critical issue put forward relates to the behavior of banks with respect to the capital buffers that 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 amounts of equity than what can be expected by just looking at the current package. We know from empirical studies that weaker capitalized banks typically exhibit weak loan growth compared to other better-capitalized banks. We also know that 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.

While the crisis has clearly had global ramifications, its impact on financial systems has not been uniform across the world. Financial structures differ greatly between countries and there needs to be scope for different countries to tailor solutions to their circumstances and structures, while, at the same time, doing so within a globally agreed framework. For instance, 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 that would challenge such models.

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

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. We should not underestimate the difficulties on the road to accounting and regulatory convergence.

How can we reduce the procyclicality of financial systems?

Our accounting and prudential regimes have increased procyclicality in recent years. This is detrimental to a stable flow of credit to the economy. In a mark-to-market environment, asset price increases quickly translate into a larger capital base of financial institutions, which, in turn, trigger additional demand for assets and a further increase in their prices. A spiral is launched. Actually this is a kind of "inverted demand curve" where demand increases with prices and vice-versa, possibly creating 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. Reducing the scope of the mark-to-market approach and moving from an incurred loss model to a forward-looking model is essential. The ultimate objective of ongoing negotiations is to create synergies between prudential and accounting standards.

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" are useful. Other options to reduce some of the procyclicality through prudential standards include a fixed buffer or a countercyclical capital buffer. I see clear limitations to the former and challenges for the latter. In any case, such mechanisms may not necessarily be cumulative and we may have to choose.

How can we address systemic risk?

As techniques for managing and allocating risk became more sophisticated, the network of counterparties expanded in scale and in complexity. This was clearly a systemic change that was properly understood but not fully captured by regulators at the time.

The definition of systemic entities should rely on different criteria beyond size, such as interconnection, complexity or substitutability, and depend on the context in which the entity evolves. Various initiatives to deal with systemic entities are currently being discussed, including tighter cooperation between supervisors, compulsory actions on banks' structures and, more controversially, additional capital charges and/or taxes and levies. 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 also echoes concerns about the activities and business models of some institutions. 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 that this cannot hold as a general lesson from the crisis. Indeed, the banks that suffered most from the crisis were precisely those that were more specialized, such as investment banks. By contrast, large universal banks, reliant on a large deposit base, were able to withstand the shocks comparatively better.

To deal with systemic risks, there is a lot of merit in taking a closer look at what I would call "market options". To reap the benefits of financial 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 (such as interbank and derivatives markets) may bring us a long way towards reducing them, provided these CCPs are properly regulated. In this respect, I think that locating these infrastructures in the same area as that of the currency they deal in and allowing them access to central bank money are key factors.

A last option which is currently gaining some international momentum concerns the possible taxation of financial institutions and activities. In principle, this idea seems quite appealing. However, the diversity of objectives that may be given to such a tax shows that the policy

debate must be clarified. In a financial crisis prevention perspective, it is aimed at changing incentives and at forcing financial intermediaries to internalize the risks that their activities generate for the whole system. In a crisis management perspective, it should enable governments to recoup the costs of financial bailouts in a systemic crisis.

My main concerns regarding this issue are twofold. My first point concerns the articulation with regulation. The added value of a tax over prudential regulation still remains to be demonstrated for countries, such as France, that have taken advantage of an effective regulatory and supervisory framework and in which public interventions in the financial sector have entailed no net costs to the government. My second point concerns the mitigation of moral hazard. We absolutely have to avoid situations in which the payment of taxes or levies is understood as a *de facto* bailout policy insurance. In this respect, the allocation of the tax to a resolution fund or to the general budget does not enable public authorities to totally remove such a risk.

Against this background, I think that an adequate, median way would be to extend the mandate of National Deposit Guarantee Schemes to early intervention tools and resolution powers. Moreover, we should build on the experience gained from *ex ante* risk-sensitive premiums, which seem to be very important for mitigating moral hazard.

Most of these remarks have focused on the major and vital incentive to enhance financial regulation. Let me conclude by looking into the future. A macro-prudential policy framework could provide further room for manoeuvre. Indeed, the crisis has illustrated the necessity to have a wider spectrum when designing financial regulation. We should also not forget that financial intermediaries are primarily tools to promote a stable financing for the economy. That said, in practice, developing a well-articulated macro-prudential policy framework raises some challenges. I trust that the benefits of addressing them are worth the impressive hard work currently underway.

Thank you for your attention.