François Villeroy de Galhau: Economic Union, Financing Union, Banking Union

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Annual General Meeting of the Foreign Bankers' Association, Amsterdam, 16 November 2017.

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Ladies and Gentlemen,

It is a pleasure to be in Amsterdam today and to give the keynote speech at your Annual General Meeting. I wish to warmly thank my friend Governor Klaas Knot and FBA Chairman Leonique van Houwelingen for their kind invitation. For a central banker, Amsterdam is a highly significant place, especially because the Bank of Amsterdam, in Dutch the "*Amsterdamsche Wisselbank"*, which was established as early as 1609, can be considered a precursor to central banks, before its role was taken over by the Nederlandsche Bank, which is also a venerable ainstitution since it was created by King William I in 1814. Furthermore, for a long time, Amsterdam has been an economic and financial capital and a major city at the heart of Europe. If I add your tradition of freedom and tolerance, your country is a paragon of many of the European virtues that we cherish.

This afternoon, I would like to share with you some reflections as a central banker on a highly topical issue: the future of Europe. Your new Minister of Foreign Affairs, Halbe Zijlstra, gave a speech on this very theme last week and rightly called for "a Europe that is relevant to its people [and] which is again synonymous with prosperity and growth". This issue is topical also because it is the right time to step up the pace in Europe. Indeed, we have clearly succeeded in building a Monetary Union, but this is not sufficient. It is urgent to make concrete progress on Economic Union, on which we have not yet delivered. We are living in a time of unique historic opportunity: first, the economic context is now favourable to move forward, since euro area growth should be at least 2.2% in 2017; "when the sun is shining, it is time to fix the roof". Second, after the recent elections in France, Germany and the Netherlands, we have a "democratic alignment", in terms of the calendar and probably in substance, for the four years to come. Lastly, the Brexit vote and the election of Mr Trump in the United States have come as external stimuli, showing how important it is to breathe new life into European integration so that we Europeans take our destiny into our own hands, as Chancellor Merkel rightly said in Munich last spring. In my remarks today, I will explore three economic concentric circles: first the Economic Union, by presenting the accelerators that are needed to make concrete progress; second the Financing Union, by focusing on one of these accelerators, which might be of particular interest to your community of banks and financial institutions; and third the Banking Union, which is a key part of the Financing Union and which has to be completed.

It is now time to act in Europe: four accelerators of the Economic Union

In Rome, on 25 March of this year, the Member States all expressed their clear willingness to work "towards completing the Economic and Monetary Union". We are in agreement on the "**why**". Let me say one word about our monetary policy. Taking into account our progress, the Governing Council decided at the end of October to pursue a gradual normalisation. We will clearly follow this path of gradual normalisation, with caution but combining the whole range of our instruments – and there shouldn't be excessive focus on the net purchases of assets. But monetary policy cannot be the only game in town, and therefore we should not overburden it. Furthermore we aim at greater **stability**, to counter the risk of a new crisis befalling an unprotected euro area, with all its damaging political and economic repercussions; and greater **growth**, to catch up our past lag on the United States and finally treat the fatal disease of mass unemployment in Europe.

With this objective in mind, **how,** concretely, can we make progress on Economic Union? In my view, we should trigger four accelerators: a **macro** accelerator, which would consist of a collective economic strategy shared by all euro area Member States; a **micro** accelerator, which would take the form of a Financing Union for Investment and Innovation, going beyond the Capital Markets Union; a **fiscal** accelerator, which would draw on a euro area budget. The fourth is not an accelerator in substance, but rather a "facilitator" for the first three: in terms of **institutions**, we would need a euro area Finance Minister and Parliament.

These four accelerators are needed, but this does not mean they all have to be implemented at the same time. With the existing Treaty, we can take steps straight away on the first two accelerators, macro and micro, on which I will elaborate.

The **macro accelerator** is **a collective economic strategy in the euro area**. It is premised on one simple fact: economic growth and employment would be stronger in the euro area if we combined more reforms in countries where they are needed, like France or Italy, and more stimulus in countries with leeway for it, like Germany or the Netherlands. To achieve this, euro area Member States have to seal a deal, which could be prepared and adopted as early as 2018.

National reforms are obviously a prerequisite to any enhancement of the Economic Union. I take this opportunity to welcome the successful reforms carried out in the Netherlands in recent years, especially in the labour market. Real GDP is expected to grow here by 3.2% in 2017 and the unemployment rate is likely to reach 4.8% in 2017, close to full employment.

Stepping up reforms is now a priority in France too, with a focus on two main areas: on the one hand, sustainably consolidating our public finances, and on the other, aiming to achieve a structural economic transformation, with a major simplification effort in the labour market, and large-scale investment in education, vocational training and apprenticeships. The new government, under Mr Macron's Presidency, has made decisive steps in that direction with the labour market reform voted this summer and already implemented, and a forthcoming reform of unemployment insurance, vocational training and apprenticeship next year. At the same time, measures have been taken to reduce the tax burden on investment. Moreover, decisions have been taken to reduce the government deficit. For the first time in 10 years, the government deficit should be below the threshold of 3% of GDP in 2017 (2.9%).

The micro accelerator: a Financing Union for Investment and Innovation

Let me now focus on the micro accelerator for the Economic Union, which is the second concentric circle. This micro accelerator would take the form of what I call a **"Financing Union for Investment and Innovation**". The euro area is experiencing an excess of savings relative to investment of about 350 billion euros per year, which is more than 3% of GDP. The aim of such a Financing Union is to better steer these savings towards productive investment, notably by shoring up **equity** which is the key to an innovation economy.

Several key initiatives contribute to this Financing Union and already exist: (i) the Capital Markets Union, which promotes the diversification of private financing; (ii) the Juncker Investment Plan, which mixes public and private investment towards the real economy; and (iii) the Banking Union, which addresses persistent financial fragmentation. These initiatives, however, lack the unified governance of a Financing Union, which would help circumvent bureaucratic barriers and foster synergies.

In addition, progress towards a Financing Union is still needed in **four key areas**:

- First, providing incentives for cross-border investments – mainly in equity – through accounting, taxes and insolvency laws. Strengthening the free movement of capital within the EU requires overcoming a wide range of legal obstacles. We should improve the predictability of insolvency frameworks, eliminate tax-related biases that penalise equity and harmonise the accounting rules for small businesses;

- Second, developing pan-European savings products more oriented towards long-term investment. This could be done through a variety of savings vehicles: the creation of European venture capital funds, new market initiatives for green bonds, securitised portfolios that are diversified across member states, and so on and so forth;
- Third, completing the Banking Union;
- Fourth, controlling financial activities and risks that are of vital importance for the euro area, such as supersystemic CCPs.

Improvements in these four areas are needed so as to reach significant gains for digitalisation, SME's scaling-up or energy transition. In each of these fields we have significant investment needs.

As part of the Financing Union, completing the Banking Union

Allow me now to dwell for a moment on the third area of progress, which is also my third concentric circle: **completing the Banking Union**. The Banking Union is a major step forward for the euro area and is now operational, based on the single rulebook and – already – two pillars: the Single Supervisory Mechanism (SSM) since end-2014; and the Single Resolution Mechanism (SRM) since the beginning of 2016. Those two pillars will have to be complemented by a third pillar: Deposit Insurance, where we could find practical and reasonable compromises. But there are two additional challenges that are less often mentioned: consistency, and consolidations.

The first challenge in order to complete the Banking Union is to **achieve better consistency between regulation, supervision and resolution**, at three levels:

- First, in the **concrete mechanisms**: finalising and simplifying the resolution pillar should be a priority. The case of the Italian banks has illustrated just how complex it is to combine the resolution regime laid down in the Bank Recovery and Resolution Directive (BRRD) with the State aid framework for orderly liquidation. In addition, confidence in the Single Resolution Fund (SRF) and its capacity to intervene has to be bolstered. The setting-up of a common backstop, as mentioned in the European Commission's communication of 11 October, is a promising avenue, which could take the form of a credit line granted by the ESM. Furthermore, the issue of the **liquidity** of the newly resolved entities – mainly the "good banks" – is not sufficiently clearly addressed: liquidity support by public sources beyond what can legitimately be expected from the Eurosystem should be clarified.
- Second, consistency in the **legal framework and requirements**: faced with the accumulation of new and "separate" requirements, we need to adopt a holistic and consistent approach in order to avoid a prudential overload. In particular, the TLAC requirement resulting from the new international framework requires a consistent adaptation of the European minimum requirement for own funds and eligible liabilities (MREL). In the same vein, the consequences of an internationally agreed Basel III package – if and when it comes – should be carefully taken into account, as it would lead to increased risk-weighted assets, which will in turn impact the MREL. All this, combined with pillar II capital requirements, could lead to over-calibration: each individual decision may be warranted; but their somewhat disorderly accumulation is not. And obviously, we must not jeopardise the level playing field between euro area banks and their international competitors.
- Third, in the **interaction between authorities**, which should be improved: the case of Banco Popular, although it was a success, has also demonstrated the importance of swift and close cooperation between supervisory and resolution authorities, both at European and national levels. In this respect, there is still a need to better coordinate the roles of the different European authorities – SSM and ECB, SRM, Commission, and EBA – in order to

have a clearer “pilot in the plane” in crisis management. At a later stage, we should even consider establishing a single banking authority for our single Banking Union, acting to bolster the robustness of the European banking sector.

The second challenge is **to support cross-border bank consolidations in the euro area.** You, the “foreign” bankers in the Netherlands, are probably especially sensitive to that. The head of the SSM too, Danièle Nouy, insisted on this point last week. We still lag far behind the American market in this respect: the market share in the United States of the top five banks is more than 40% whereas the market share in the euro area of the top five banks is less than 20%. Sound and safe cross-border consolidations would make banks better able to diversify their risks across the euro area, and channel savings more effectively towards investments across borders; this would foster the Financing Union I talked about.

From a **supervisory** point of view, it involves supporting an approach on a consolidated basis by granting more waivers on liquidity and capital so as to allow more flexible capital allocation and limit ring-fencing. Swift execution of cross-border transactions is also essential: the implementation of a fast-track process by the SSM would address this issue. From a **resolution** point of view, internal MREL requirements could be a tool to facilitate the resolution of institutions, but they would become meaningless if calculated on a national basis. Indeed, having internal MREL in all countries could be an obstacle to the single market and European banking cross-border mergers. Finally, we should address business and legal impediments to cross-border mergers: information asymmetry, non-performing loans (NPL) or anti-takeover legal structures in different countries. As a first concrete step, I suggest that the European Banking Authority publish a comprehensive stock-taking of all the regulatory and supervisory obstacles to cross-border activities and mergers. The aim is crystal clear: within a Monetary and Banking Union, a cross-border merger must not be more difficult and cumbersome than a “domestic” merger. The logic of the banking union is that it should be considered for banking purposes as a unique jurisdiction.

Before I conclude, I would like to add a few words on **financial regulation**. No one, I hope, can seriously dispute that after the financial crisis it was necessary to significantly strengthen regulation to reduce risks. Is there any need to recall the disastrous consequences that this crisis inflicted on the real economy, the social dramas, and the democratic fragmentation with the rise of populism? Financial stability is a common good that needs to be guaranteed. Remarkable achievements have been carried out since 2009 under the impetus of the G20 and the Financial Stability Board. For banks in particular, the majority of the Basel III work – let’s say 80% – has already been done in 2010–2011. However, discussions remain ongoing on the question of the measurement of risk on bank balance sheets. It is in the strategic interests of France and Europe, which has always promoted international rules, to conclude a final agreement on Basel III. We are working hard towards a fair and reasonable agreement.

But beyond Basel III, we should **finalise measures that target non-banks.** We must ensure a balance between financing channels. The priority has now shifted from the solvency of banks, which has improved substantially, to the liquidity of the shadow banking sector, particularly funds and asset management companies that are exposed to the risks of sudden panic-driven runs.

Let me conclude my speech by quoting a French Philosopher, who spent many years in the Netherlands: René Descartes. He was both the father of “l’esprit cartésien” – having a clear vision of our aims – and a pragmatist, with this useful principle: “divide each of the difficulties under examination into as many parts as possible and as might be required in order to resolve them better”[1]. Indeed, we must not get bogged down by misunderstandings, sterile debates and considerations about which of the intergovernmental or community method to use. But in order to move forward, we should combine a holistic vision and a stepwise approach to implementation. This is what I have been endeavouring to do in my speech today: I identified areas where concrete progress can be made rapidly. We should not let this historic opportunity slip: it is now or never. Thank you for your attention.

[1] *Discourse on the Method*, René Descartes, 1637.