François Villeroy de Galhau: Monitoring large and complex institutions

Welcome address by Mr François Villeroy de Galhau, Governor of the Bank of France and Chairman of the Autorité de contrôle prudentiel et de resolution (ACPR), at the ACPR Academic Conference, Paris, 11 December 2017.

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Good morning,

I am very pleased to welcome you to this high level academic conference jointly organised by the Financial Stability Department of the Banque de France and the French Prudential Supervision and Resolution Authority (ACPR). This year, the conference will focus on the challenges posed by the monitoring of large and complex banking institutions.

It is true that large global banks might look complex. The 2008 Great Financial Crisis showed how highly interconnected financial institutions that were exposed to overly complex derivative products could spread and amplify domestic shocks. Since then, the “too-big-to-fail” issue has been put high on the agenda of the Financial Stability Board and significant progress has been made in this regard. However, there is evidence that some global banks are growing bigger and perhaps becoming even more complex than before.

Complexity is not in itself a drawback. After all, the globalisation of trade might require a certain dose of complexity either due to the nature of the financial products required to hedge against traditional or newly emerging risks, or due to the organisational structures that result from cross-border activities. Similarly, one should not preclude the diversification benefits associated with large global financial institutions exposed to partially correlated domestic markets. The true question is how to strike the right balance between the diversification benefits that arise from multiple businesses financing the real economy and the potential weaknesses in risk management caused by this increased complexity.

This morning, I will start by quickly reminding you of some key features of the complexity of the global banking system before the financial crisis. Then, I will give a short overview of the strong regulatory and supervisory actions undertaken to reduce inefficient levels of complexity. Lastly, I will mention two important challenges we face today in shaping the global European banking system.

A – Some stylised facts from the pre-financial crisis period: organisational complexities and complex activities

Before the Great Financial Crisis, we observed a steady increase in the number of foreign banks, from 784 in 1995 to 1,301 in 2007, according to Claessens and Van Horen (2014).[1] At the same time, the number of domestic banks decreased and, as a result, the relative importance of foreign banks increased substantially, from a share of 19% in 1995 to 32% in 2007. This rise might be attributable to structural factors such as technological advancements, capital market liberalisations and economic integration.[2] It was accompanied by the growing importance of wholesale funding markets in financing banking activities and it resulted in a high degree of interconnectedness between financial institutions.

Beyond the potential complexity of global banking’s organisational structures, the financial crisis was also preceded by increasing complexity in banking activities and financial products. For example, the gross market value of the OTC derivative markets increased from USD 2 trillion in 1998 to USD 35 trillion at the end of 2008. The intensive use of complex and off-balance sheet products distanced the final borrower from the final investor. As underlined by a recent IMF study, most of the pre-crisis financial globalisation had taken place through cross-border activities with little involvement from global banks in local retail activity. It ultimately led to a reduction in efforts from banks to monitor the creditworthiness of their borrowers and mitigate the associated default risks.

These two levels of complexities were exacerbated during the European sovereign debt crisis as European banks were put under funding pressures by market participants concerned by the opaqueness of their portfolio composition and the lack of credibility of the previous resolution mechanism.

B – A comprehensive and strong policy response: both on the regulatory and the supervisory sides

However, I just want to convince you of how strong the regulatory and supervisory responses have been since then, in curbing the detrimental impacts that overly complex organisations or overly complex activities might produce.

First, the new regulatory framework treats global and complex banks differently. Global Systemically Important Banks (aka GSIBs) are subject to higher capital requirements explicitly determined by the importance of their cross-jurisdictional claims and liabilities, their OTC derivatives, and their Level 3 assets exposure. They will range from 1% and possibly up to 3.5% of the CET1 ratio after the phase-in period (e.g. 2019).

We have seen in the past that complex financial institutions relied too much on wholesale funding that could quickly evaporate in times of stress; the new liquidity ratios (LCR, NSFR) help to promote the short-term resilience of the liquidity risk profile of banks and a sustainable maturity structure for assets and liabilities. The recently agreed finalisation of Basel III reinforces the monitoring of internal models and capital requirements on more complex activities, including the FRTB, the CVA[3] and the CTP[4] on market activities.

Before 2008, we lacked the tools to implement an orderly restructuring of a bank that was failing or likely to fail. The Bank Recovery and Resolution Directive now requires banks in Europe to establish resolution plans (also called “living wills” by the US regulators) to anticipate the restructuration needed in case of trouble. By defining *ex ante* the seniority of every creditor and by making it possible to bail-in some of these creditors (including some senior unsecured debt) in case of crises, we should have potentially limited the need for public funds to resolve private bank failures.

Second, not only banking regulation but also the enforcement of its supervision have positively reduced the detrimental effects of bank complexity. The new supervisory framework is more consistent and harmonised. In the SSM area, large global banks are now subject to a single supervisor, associating the ECB with national supervisors in JSTs, as is also the case for their local foreign subsidiaries.

The euro area banks have been subjected to wide-ranging and harmonised supervisory exercises. Stress testing exercises that apply a common methodology and common quality assurance have been performed every two years since 2011 under the aegis of the EBA. A transparency exercise is run every year by the EBA, generating lots of data on European banks. Publicly disclosed asset quality reviews and comprehensive assessments have been performed each time a bank is put under the direct supervision of the SSM since 2014. A large review of the internal models used by the European banks (Targeted Review of Internal Models, or TRIM) is currently performed by the ECB and aims at greater reliability and comparability of risk models and capital.

In sum, we have set up a regulatory framework in Europe that penalises unnecessarily complex banking activities by imposing higher capital requirements, allowing for more intrusive and comprehensive supervision and fostering greater transparency. The new resolution mechanism aims at extinguishing the implicit government guarantees, which provide an incentive for excessive risk taking and levels of complexity in order to gain “too-big-to-fail” status.

C – Some challenges lie ahead: better coordination of the parties involved in the resolution process and the necessity for cross-border consolidations in Europe

But we still face important challenges ahead. I want to stress two of them. The Single Resolution Mechanism, the second pillar of the Banking Union, has just successfully passed its first real test this summer with the orderly resolution of Banco Popular. However, there is still room for improvement in the coordination between the numerous institutions and authorities involved in these procedures. It means that every participant must know and very clearly understand its role in the process to ensure an efficient resolution.

Second, Europe still suffers from overcapacity and cross-border consolidation is needed. In the United States, the top five banks have a market share of more than 40% while this figure is barely 20% in Europe. Given the new regulatory and supervisory framework I described earlier, we believe that the Banking Union should be considered – according to the criteria set up by the BCSB – as a single geographic area. Furthermore, we are reaching the point in Europe where facilitating healthy and well-designed cross-border mergers could actually improve financial stability. It would make banks better able to diversify their risks, achieve economies of scale and become more efficient. And as we have strengthened the single supervision and resolution of significant institutions, we should not fear the “too-big-to-fail” issue. CrossIborder consolidation would foster a more efficient allocation of savings towards productive investments in Europe and it would place European banks in a better position in terms of international competition.

To conclude, interactions between policy makers, researchers and practitioners are very valuable and I am certain that this conference will contribute to fuelling these interactions. We strongly believe in the positive spillovers from the research function being closely intertwined with the supervisory and financial stability divisions. In particular, empirical evaluations and theoretical works on policy design – and we will see some of them presented today – are absolutely necessary in order to fine tune and reinforce the regulatory reforms that have been implemented not only in Europe but worldwide.

I wish you a very fruitful conference and I will give the floor right away to Henri Fraisse, who will chair the first session. Thank you for your attention.

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1 Claessens, Stijn and van Horen, Neeltje (2014), “The Impact of the Global Financial Crisis on Banking Globalization”, *IMF working paper* 14/197. Their data set covers 138 host countries for the period 1995–2013.

2 Focarelli, Dario and Pozzolo, Alberto (2005), “Where Do Banks Expand Abroad? An Empirical Analysis”, *The Journal of Business*, 78, Issue 6, pp. 2435–2464, EconPapers.repec.org/RePEc:ucp:jnlbus:v:78:y:2005:i:6:p:2435–2464.

3 Credit Value Adjustment.

4 Correlation Trading Portfolio.