Conference of the ACPR – Palais Brongniart, 8 June 2018

The major issues at stake in the review of prudential supervision of banks

Speech by François Villeroy de Galhau,

Governor of the Banque de France,

Chairman of the *Autorité de contrôle prudentiel et de résolution* (ACPR)

Press contact: Mark Deen (mark.deen@banque-france.fr).

Ladies and Gentlemen,

I am very pleased to welcome you to this conference of the *Autorité de contrôle prudentiel et de résolution* (ACPR), which this morning focuses on major issues at stake in the review of prudential supervision of banks. The subject is not new, but it is always topical. Let me first stress the greater degree of security already achieved in prudential matters: the agreement of 7 December 2017 on the finalisation of Basel III and the now standard use of macroprudential instruments. I will then touch on what remains to be done in Europe, specifically the completion of the Banking Union, an essential step.

**

I. The implementation of the Basel III agreement of 7 December 2017 in Europe, fully respecting the envisaged timetable, is essential

The finalisation of **Basel III** – and not of Basel IV, definitely not – brings to an end a decade of regulatory efforts which have considerably strengthened the resilience of the international banking system. I reiterate that the agreement of 7 December 2017 is the best possible agreement for France and for Europe. It is balanced and reasonable: the risk sensitivity of the prudential framework has been preserved thanks to a large-scale retention of the internal model approach, which was one of our main concerns. Moreover, trust in the internal models will be strengthened by greater oversight, while the increase in capital requirements will remain moderate and spread out until 2027. Banks were rightly calling for long-term strategic visibility for their regulatory framework: they now have it.

The agreement that we have negotiated relies on a strong commitment to implementation by the main jurisdictions, including the United States. The European Union must of course keep its word with regard to implementation and the timetable.

Additionally, we are confident about the rapid completion of the current discussions on the standardised approach to **market risk**. The first version of the text, published in 2016, would have entailed ex post an unjustified and excessive increase in the capital requirements for market activities. The ACPR has since then actively participated in the work of the technical Market Risk Group of the Basel Committee. The new rules proposed in the document currently submitted for consultation should permit a return to the impacts initially sought ex ante, i.e. an average increase of 20% to 30% in the minimum capital requirement for market risks.

Beside regulation – thus clarified – and microprudential supervision, **macroprudential policies** now round off in many countries the financial stability trifecta. In France, the ACPR contributes actively to the discussions of the Haut Conseil de Stabilité Financière (High Council for Financial Stability – HCSF) chaired by the Minister for the Economy and Finance. In the face of rapid and excessive growth in the debt of several large corporations, the HCSF has adopted a measure which comes into force on 1 July; it imposes on French systemic banks a limit to their exposures to the most leveraged large non-financial resident corporations. The HCSF nevertheless remains vigilant in the face of the rapid increase in bank lending to the private sector, which stood at +5.5% in the first quarter of 2018. French private debt reached 130% of GDP at end-2017, the highest of the large countries in the euro area. Since 2014, it has risen by more than 9% of GDP, while it has declined by 5.4% of GDP on average for the euro area. The HCSF stated on 29 March that it stands ready to act. In particular, if we have to decide, at our next meeting, on a countercyclical capital buffer, that would evidently not be in order to stop the lending today: it would be – as the name suggests – to avoid a credit crunch tomorrow when there is a cyclical downturn in the economy, particularly for small and medium-sized enterprises. Should banks lack sufficient capital, they could manage the heightened risks thus materialising in their balance sheets by restricting new lending. It is this excessive credit cycle – the risk of “go and stop” seen during financial crises – that a moderate capital buffer must seek to smooth out. It should be noted in passing that a clear majority of Member States of the European Union have adopted other macroprudential measures to specifically limit residential lending, constraining households: in my view it is out of the question in France.

II. <u>To reduce fragmentation and improve private risk sharing in Europe, we must now complete the Banking Union</u>.

We must now resolutely work towards completing the European Banking Union. I would first like to explain why. The finalisation of the Banking Union should, alongside the Capital Markets Union, contribute to improving private risk sharing within the euro area. Private risk sharing fulfils an economic stabilisation function: in the United States, for example, private financial flows between the federal states are a more powerful damper than budget mechanisms involved in public risk sharing. Furthermore, this private risk sharing should help to channel the euro area's large savings surplus – EUR 390 billion in 2017 – towards European companies, within a real Financing Union for Investment and Innovation at the European level.

We have taken a step forward with the agreement of 25 May at the Ecofin Council meeting on the "banking reform package" set out in the Commission's legislative proposal of 23 November 2016. Even if we need to wait for the Parliament's proposal and the outcome of the trialogue discussions, this agreement is overall positive. On the supervision side, it provides the European Union with all the prudential ratios of the international framework. It also provides for the gradual introduction of the revised market risk framework, the Fundamental Review of the Trading Book (FRTB), which is still being finalised in Basel. In addition, a first step has been taken towards recognising the euro area as a single jurisdiction, in which cross-border exposures within the Banking Union are considered domestic exposures for measuring the systemic importance of European banks. On the resolution side, we have obtained an agreement to broaden the subordination requirement of the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) to beyond global systemically important banks (G-SIBs), thereby reducing the threshold effect between G-SIBs and other banks. In addition, the text defines a subordinated debt ceiling, very close to the international Total Loss Absorbing Capacity (TLAC) standard.

However, this agreement contains a number of more problematic aspects about which we shall remain vigilant. To name but one, as regards the internal MREL, cross-border exemptions within the Banking Union similar to the methodology for calculating the capital surcharge for systemic banks would have been desirable. In addition, we are concerned about a reference to the threshold allowing access to the Resolution Fund being introduced into the calibration of the internal MREL; this makes no sense when resolution is carried out at parent company level.

As regards the measures still needed to finalise the Banking Union, **completing the resolution framework** is, in my opinion, the first priority, even more so than deposit insurance, the third pillar of the Banking Union. Mario Draghi was most insistent on this in his Florence speech of 11 May.[i] In most large jurisdictions – the United States, the United Kingdom and Japan – the intervention capabilities of resolution funds are not capped because they are backstopped by the fiscal authorities, without being a burden on public finances, since any public outlays are generally reimbursed by the private sector. During the last financial crisis, market and depositor confidence resulting from a credit line backstopped by the US Treasury enabled the Federal Deposit Insurance Corporation (FDIC) to resolve 500 banks without tapping into the resources of the safety net.[ii] Today, in the event of a severe crisis in the European Banking Union, the resources of the Single Resolution Fund (SRF) could be depleted.

This is why a common backstop for the Single Resolution Fund is urgently needed. Let me emphasise that the aim of a common backstop is not to bail out banks or draw on government budgets. Such a step would only be taken in accordance with the principle of subsidiarity, and all the sums borrowed would be gradually repaid by the banking sector. Rather, it is about building confidence in bank resolution in Europe by showing that it will always be able to intervene effectively in the event of a crisis. Such a system will also encourage the lifting of the constraints imposed by certain national authorities on capital and liquidity flows. I regard the European Commission's proposal to set up a backstop through a credit line provided by the European Stability Mechanism (ESM) as a top priority. We also need a common scheme for providing liquidity to financially sound banks after resolution which is in line with euro area monetary policy rules.

Of course, a compromise will have to be found in order to make headway on the third pillar of the Banking Union, **deposit insurance**. Once we have completed the resolution framework, we will be less in need of a shared European scheme. A pragmatic approach could be to introduce a system of loans between national deposit guarantee schemes (DGS), with guarantee mechanisms to ensure that liquidity advances do not lead to losses for the lending DGS. This would lead to a sharing of liquidity without sharing risks, which would be a first step towards shoring up financial sector confidence and strengthening depositor protection.

**

To conclude, I would like to stress that the completion of the Banking Union in Europe is one of the key elements of a broader ambition: the crucial strengthening of Economic Union. As Mario Draghi said on 11 May: "The people of Europe have come to know the euro and trust the euro. But they also expect the euro to deliver the stability and prosperity it promised. So our duty, as policymakers, is to return their trust and to address the areas of our union that […] are incomplete". Beyond national democratic debates – there is no shortage of such debates today, both in Europe and elsewhere – this confidence in the euro is our shared asset everywhere. We are bound by this trust, while needing to respect reality, but also the urgency of time and – I think – of History.

[i] "Risk-reducing and risk-sharing in our Monetary Union", Speech by Mario Draghi, President of the ECB, at the European University Institute, Florence, 11 May 2018

[ii] Sapir, A. and Wolff, G. (2013), "The neglected side of banking union: reshaping Europe's financial system", note presented at the informal ECOFIN meeting in Vilnius on 14 September 2013.