

Denis Beau: Denis Beau: Monetary and financial challenges for the Euro area - what are our options?

Speech by Mr Denis Beau, First Deputy Governor of the Bank of France, at the Faculty of Economics and Management, Strasbourg, 28 February 2019.

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Ten years after the crisis, the ability of the global financial system, and especially the European financial sector, to withstand shocks appears to have been significantly reinforced.

This reinforcement is the result of numerous changes which vary in nature:

Banks now have more capital and its quality has been improved. Their transformation activities are better regulated and they have larger liquidity buffers.

In Europe, the banking sector has also been made more resilient through major institutional reforms, especially the creation of the Single Supervisory Mechanism under the aegis of the ECB and the Single Resolution Mechanism.

Outside the banking industry, the reforms steered by the G20 have enhanced the functioning of financial markets (particularly derivatives markets), improved the oversight and regulation of developments in non-bank financial intermediation (shadow banking), and put in place a framework for monitoring and safeguarding the stability of the financial system as a whole through the implementation of macroprudential policy.

The crisis has also prompted changes in the way financial institutions operate. One of the most visible ones is that risk and compliance functions have now become an essential part of their organisations. In a more subtle way, there have also been changes in the culture of these institutions, with greater emphasis now being placed on good governance and on the “purpose” of certain activities or the “service” provided to clients.

This strengthening of the financial system’s resilience is a major source of confidence at the start of 2019, in an environment marked by mounting geopolitical uncertainties and slowing economic growth. But it is not time for complacency. One of the core challenges we face, particularly in the euro area, is preventing and limiting the impact of new potential shocks.

“Madame la Vice-Présidente”, you have invited me here today to share a central banker and supervisor’s perspective on the different options open to private and public agents for meeting these challenges. Rather than talking about options, I would like to emphasise two “burning obligations” that fall on all of us, namely:

- ♦ for financial intermediaries, micro and macroprudential supervisors, maintaining a strong vigilance (I.); and
- ♦ for regulators and the private (financial) sector promoting a deeper financial integration of the euro area (II.).

I. Continued strong vigilance is needed to navigate through an increasingly uncertain world

a. Persistent threats

Against a backdrop of intense geopolitical uncertainty and a less favourable macroeconomic environment than expected, the financial industry faces a combination of very “traditional” risks and some relatively new ones.

Since the summer, there has been a series of negative surprises: a resurgence of trade tensions between the United States and its partners, notably China; tensions surrounding the Italian budget; the British parliament's rejection of the Brexit deal; and, closer to us, the scale and duration of the so called *gilets jaunes* movement.

This climate has weighed on the macroeconomic environment, which is now unquestionably less favourable than anticipated a few months ago. According to the IMF, global growth could slow to 3.5% in 2019 from 3.7% in 2018. France's economic growth is also slowing, albeit to a lesser extent than in other European countries thanks to a rise in purchasing power and robust domestic demand. In 2019, France should grow at a pace faster than in Germany, and close to the average pace for the euro area.

This context of uncertainty exacerbates risks already faced by financial intermediaries.

Debt levels among economic agents remain high. This is particularly true for France where debt has been rising consistently over the past fifteen years, and now stands at 75% and 60% of GDP respectively for non-financial corporations and households – in stark contrast with the trends observed in neighbouring European countries and other advanced economies. The downward revision to growth forecasts raises even greater concerns over the sustainability of this debt and the amplifying role it could play in the event of an upward shock to interest rates or a downward shock to activity.

Similarly, it makes the (still necessary) process of balance sheet cleansing even harder for those financial intermediaries that have been unable to finish it or have put it off since the last crisis, and still bear the scars in the form of legacy non-performing loans.

The increased uncertainty in the macroeconomic and geopolitical environment is also weighing on markets, where valuations still seem elevated in a medium-term perspective. This raises the risk of abrupt and marked downward corrections in financial asset prices, particularly as market liquidity seems more fragile since the last financial crisis.

From a more forward-looking perspective, the downward revision to growth forecasts could prolong the current low interest environment which, despite being overall consistent with the macroeconomic situation, still has implications for (more) economic agents' borrowing and for the (weaker) profitability of financial intermediaries.

Added to these clearly identified cyclical risks are a number of new, structural risks – among them those arising from the increasing digitalisation of the financial industry.

Digitalisation in finance is being driven by a combination of cutting-edge technological developments (big data, cloud computing, artificial intelligence or blockchain technology), which are transforming the way financial products are designed, developed, distributed and managed. Digital transformation offers the promise of better user experiences, more diversified sources of financing for the economy, lower production costs and greater efficiency in the financial system.

But it also raises three types of risk.

First, it requires huge investment, the management of complex projects and greater agility on the part of financial institutions. As a result, although necessary and desirable, the digital transformation of financial intermediaries carries a significant execution risk. This is the first type of risk to which we are exposed, and one that is highly idiosyncratic, but we need to recognise it.

Next, digitalisation is challenging existing business models and their profitability, which can have destabilising effects in a banking industry such as Europe's where there are overcapacity issues and where profitability is rising but remains well below US levels.

The third type of risk is that digitalisation gives operational risk a more systemic footprint. In a

largely dematerialised world where financial services can be accessed via multiple channels, cyber-risk poses an increasingly significant threat. Similarly, the use by financial intermediaries and their operational reliance on a small handful of providers of “suites” of technological solutions, and not just softwares, raises the risk that a service disruption might impact the entire system and not just a single entity.

b. What are the priorities for microprudential supervisors?

In light of these complex and interconnected risks, and the fact that a significant portion of them are new, financial intermediaries and supervisors need to exercise vigilance in order to understand the exact nature and impacts of the threats, and take appropriate steps to contain and manage them. For the SSM, this vigilance requirement has led to the establishment of three supervisory priorities for 2019:

- ♦ first priority is, given the continuing high level of outstanding non-performing loans, to monitor the euro area banking industry’s credit risk by providing further strong incentives to lower exposures – efforts which have already resulted in a substantial reduction;
- ♦ second priority is to ensure that institutions manage their risks appropriately, including behavioural aspects such as customer protection and the prevention of money laundering, the significance of which has become abundantly clear in recent years;
- ♦ third priority is to manage multidimensional risks, the most pressing of which being Brexit. The SSM’s priority in this respect is clearly to ensure that euro area banks operating in the United Kingdom and vice versa have drawn up contingency plans to cope with the loss of European passporting rights after Brexit.

c. What role can macroprudential policy play?

Macroprudential policy can play a complementary role alongside microprudential supervision by following a more preventive approach that addresses the financial system as a whole.

Macroprudential policy can play a preventive role with regard to debt trends and to the financial cycle: the current phase of the cycle is conducive to greater risk-taking, and the French macroprudential authority, the *Haut Conseil de stabilité financière*, has taken steps to limit this and/or prevent negative consequences in the event of a financial shock.

The HCSF therefore keeps a close eye on markets or activities where exuberance is more likely to emerge. Over the past quarters, it has made public its concerns about developments in the commercial real estate market (i.e. the market where real estate is an asset class for financial investors), trends in debt levels among highly indebted corporations or, more recently, leveraged finance activities (especially the debt incurred by companies participating in LBOs, which is frequently sold off by originators to other financial investors).

The HCSF has also formally intervened to curb risk-taking: at the end of 2017 it decided to cap bank exposures to large and highly indebted corporations at 5% of their capital.

In addition, to limit the negative consequences for banks of increased risk-taking in the event of a financial shock, the HCSF decided in June 2018 to raise the countercyclical capital buffer to 0.25% – in other words, to require banks to set aside more capital to cover their risk exposure toward the French economy.

As a countercyclical tool, this buffer is designed to be put in place preventively, when credit constraints are low, i.e. when the economic “cost” of such an additional requirement is limited.

It forces banks to build up some room for manoeuvre that can then be used to prevent credit rationing if they incur higher-than-expected losses after a shock or turnaround in the financial cycle. Immediately releasing the buffer would allow banks to tap into this capital reserve and

support the supply of credit, especially to small and medium-sized enterprises which are the most reliant on bank financing.

Macroprudential policy is also concerned with the emerging structural risks described previously.

For example, the “platformisation” of financial activities driven by digitalisation is contributing to a profound transformation of financial intermediation – a trend also amplified by other factors: the search for yield in the current low interest rate environment; changes in financial intermediation business models in response to the macrofinancial environment and regulatory developments; the desire of firms to diversify their sources of financing to increase their resilience.

With regard to financial stability and systemic risk, these developments mean that non-bank financial intermediation is playing an increasing role in financing the economy, while macroprudential policy has been designed with reference to a bank-centric financial system.

The disruption in financial intermediation is also increasing the number and complexity of the interconnections between financial sector participants (banks, investment funds, insurers).

In both cases, macroprudential authorities need to strengthen their analytical capabilities, in order to better understand the consequences of these interconnections, eventually conducting stress tests across the entire system rather than just in individual sectors, and adapt their macroprudential policy to the new challenges.

The HCSF is fully committed to this goal. Its powers were adjusted by legislators in 2016 to allow it to intervene outside the banking industry. It has also begun carrying out coordinated stress tests across all sectors, and has facilitated the pooling and cross examination of data held by different authorities to provide a more holistic understanding of the system and its interconnections.

Although national authorities must be at the frontline of macroprudential policy, it is important to stress that these efforts cannot be conducted in isolation, particularly in the European Union and the euro area where our economies and their financing are closely intertwined.

II. The euro area needs to continue strengthening its financial integration

Euro area countries are already closely integrated on an economic level, and their financial integration should not be left half-finished. However, deeper integration will not happen spontaneously – it requires strong and determined political action. It means completing the Banking Union, supplementing it with an action plan to develop other financing channels, and creating deeper and more integrated European financial markets.

a. Why do we need to increase the euro area’s financial integration?

We tend to talk of the euro, which has just celebrated its 20th anniversary, as an eminently political project. Clearly, this is true: the single currency stands as a daily reminder of our shared European identity. As with other “European successes” such as the free movement of people, we often forget that its achievement was not a foregone conclusion.

But the euro is also an economic necessity: it was born in part from the obvious difficulties that emerged in the 1980s and 1990s in managing a single market with national currencies. Indeed economic union called for monetary union.

Similarly, the 2007–2009 financial crisis, followed by the euro area sovereign debt crisis in 2011–2012, shed a stark light on the disadvantages of having an economic and monetary union without a banking and financial union.

As the crisis unfurled, the gaps in our financial integration led to a fragmentation of financing

conditions across the euro area, which in turn exacerbated the negative effects of the shock. Some countries experienced an abrupt deterioration in both government solvency and bank solvency, triggering a vicious circle linked to their domestic sovereign-bank nexus – that is the overexposure of domestic banks to their own national government’s debt.

Today, progress has been made in resolving the institutional failings at the root of this fragmentation, with increased oversight and better coordination in fiscal policies and a more homogeneous system of financial supervision. However, financial integration remains a pressing challenge for the euro area, and one on which the future prosperity of the European Union and its citizens depends. Since the crisis, the allocation of savings and investment has remained firmly biased towards domestic markets and vehicles.

It is vital that we make progress in this area if we are to channel our savings surplus more effectively towards investment, and in particular towards the financing of European firms, especially the most innovative and dynamic ones whose development will determine our future potential growth.

Financial integration is also key to ensuring economic and financial stability in the European Union as it will enable the private sector to better absorb economic shocks and spread its risk.

Even more importantly, achieving integration will allow us to reap the full and lasting benefits of the drive towards union that began in 1957, and will ensure that the European community is more than just the sum of its parts and that Europe has weight and influence in tomorrow’s world.

b. Improving the functioning of the Banking Union...

One of the main steps towards this integration has been the Banking Union. However, its functioning needs to be adapted and improved.

The most visible aspect of Banking Union has been the implementation of a single supervisory mechanism under the aegis of the ECB.

Constructed in record time to address the main weaknesses in our banking system – the doom loop between government debt and bank debt, the disparity in national banking rights, the national bias in supervision – the Single Supervisory Mechanism is now a tangible reality that has completely transformed the way the euro area banking industry is regulated.

After just over four years of existence, the SSM today constitutes a unique and efficient model, based on the application of the EU Single Rulebook (under the direction of the European Banking Authority – EBA), close cooperation between the ECB and national authorities on all levels (ECB Supervisory Board, Joint Supervisory Teams, on-site inspections teams), and the principles of subsidiarity and proportionality (the ECB directly supervises 119 of the largest banking groups while all other institutions are supervised through national authorities).

The SSM represents a major institutional step forward and the initial results are real.

Banking supervision practices have been harmonised upwards and are now aligned with the highest international standards (for example, the methodology for the supervisory review and evaluation process or SREP).

Europe’s banking industry is today significantly more robust than before the crisis: the biggest banks’ CET1 ratio has increased by more than 3 percentage points since 2014 (from 11.3% to 14.6% at end-2017) and their balance sheets have largely been cleaned up (through a reduction in the NPL ratio from 7.6% to 4.9% over the same period).

The industry’s resilience was confirmed in the stress tests organised by the ECB and EBA in 2018, which simulated the impact of financial shocks on the solvency of the largest banks: in an

adverse scenario, the average CET1 ratio for the sample would come out at 9.9% – or 1 percentage point higher than in the previous exercise in 2016.

That said, we still have not reaped the full benefits of more harmonised regulation and more integrated supervision, and we need to make sure that we consolidate and build on the progress already made.

From a regulatory perspective, aside from transposing the Basel Accords into EU law (the CRR 2-CRD 5 package introducing new prudential requirements such as the NSFR and the leverage ratio), we need to advance further on the application of uniform regulations. We also need to pull down all the barriers to euro area banking integration by removing all regulatory obstacles to cross-border transactions – in terms of solvency, liquidity or large exposures – and by adjusting the calculation of capital requirements for systemic institutions. In short, we need to recognise that the euro area must be treated as a single jurisdiction where a single rulebook is enforced.

In terms of supervision, the priority now is to bring the largest investment firms within the scope of the SSM. We also need to increase cooperation between national authorities for the oversight of cross-border institutions (home-host relations), and for anti-money laundering and countering the financing of terrorism – the importance of which is recurrently driven home by the news.

To complete the Banking Union, we also need to render its second pillar, the Single Resolution Mechanism or SRM, fully operational.

The euro area has had a common resolution mechanism in place for banking crises since 2015. Like the SSM, the SRM is based on a common regulatory framework (the BRRD Directive and the SRM regulation), and is structured around a Single Resolution Board and joint resolution teams.

Although the SSM and the SRM have both been successful in managing the first bank liquidations or resolutions (i.e. those concerning the Veneto banks and Banco Popular), the second pillar still has to be finalised. Achieving this goal is essential, both to prevent the contagion of banking crises and to ensure the continuity of critical banking functions.

In this regard, France has worked hard for the creation of a common backstop, the main features of which were decided just a few months ago. Three issues still need to be addressed however: the duration of the credit lines provided by the backstop; the creation of a rapid decision-making process in the event of an emergency; and the provision of liquidity to banks in resolution.

Once these matters have been resolved, we can hope, and at the Banque de France it is our firm belief, that a pragmatic compromise can be found on the third pillar – the deposit guarantee scheme.

c. ... and building a Capital Markets Union to create a true Financing Union

Evidently, financial integration is not just about achieving banking union. Ensuring the balanced and sustainable financing of the economy also implies deeper integration of capital markets, which fosters greater geographical diversification in savings and meets corporate firms' financing needs – notably equity financing. It also means making better use of the savings entrusted to insurers and pension funds, to ensure the long-term financing of the European economy. Which is why France supports an ambitious review of the regulation in the sector. These overall goals for mobilising savings are also why the European Commission's 2015 project for a Capital Markets Union has garnered such a broad support.

The Commission has already implemented a significant number of measures (revision of the Prospectus Directive, creation of European long-term venture capital funds – EuVECA and ELTIF), and discussions are well underway on other topics (pan-European personal pension

product or PEPP, plan for sustainable finance, plan for fintechs).

It is clearly vital that the future European Commission, European Parliament and European Council all follow through on this action plan and complete the regulatory work.

But financial integration also requires initiatives from economic and financial actors, who need to assimilate the regulatory framework and bring it to life: we cannot develop markets for green bonds, private debt and securitisation without the issuers, investors and arrangers that make them thrive.

More importantly, a Capital Markets Union would be meaningless if, alongside the Banking Union and the Juncker Plan, it is not part of a longer-term project to create a Financing Union for Investment and Innovation.

Financial integration is therefore essential for the euro area and must form a core part of all projects relating to the financing of European economies. However, as these projects imply a profound transformation, we can only make progress with a strong commitment of all actors: legislators and regulators, European and national authorities, private and public agents.

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We are only a few weeks away from the next European elections.

Underlining the threats we face is also an opportunity to remind ourselves that, in a globalised world where size is key, our strength lies in our ability to exercise shared sovereignty.

And talking about the “burning obligation” to deepen Europe’s financial integration is also a chance to underline the real but often forgotten successes in the construction of Europe, as well as the costs and dangers of incomplete integration. It illustrates, once again, that Europe is not only a project that can benefit everyone, but also one that cannot be achieved without the full-hearted and determined commitment of each and everyone of us.