François Villeroy de Galhau: How solid is our financial system in the new economic landscape?

Speech 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 Conference of ACPR, Paris, 5 December 2022.

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Ladies and Gentlemen,

It gives me great pleasure to welcome you to another ACPR Conference, which this year naturally focuses on the theme of "Supervisors in the face of uncertainty". Russia's war against Ukraine is unfortunately continuing, and there are no indications as to how long it will last or how it will end. It is creating an uncertainty shock, and will probably, over the longer term, create a new macroeconomic and financial landscape (I). This is the new prism through which we need to view the challenges of financial stability, and, like light, it splits them into a spectrum of five questions on the French financial system (II).

I. What we know – and don't know – about the new landscape: three returns

The return of inflation and rising interest rates. Inflation has accelerated over the past few months, reaching 10% in November in the euro area and 7.1% in France, which is far too high and well above the inflation target. As a result, we, the central banks, are working steadfastly to bring inflation back towards 2% in the next two to three years. The ECB Governing Council has increased its policy rates by 200 basis points since July: we have moved closer to the neutral rate which we estimate to be around 2%, and which we should reach at our next meeting on 15 December. Let us be clear: this rate rise is good news for banks and insurers, who have long been critical of low rates. Financial institutions want the rise to be orderly: it is, very much so; but this does not mean it should be too slow, or predetermined. It is still too soon to talk about a "terminal rate": we will decide what is necessary following a meeting-by-meeting approach; and we do not steer market rates, which are sometimes excessively volatile.

The return of volatility in the markets, starting with commodity markets where margin calls reached historic highs this summer. In equity markets, after the corrections observed since the start of 2022, valuations remain relatively high. Fixed income markets are also showing strong volatility, with one extreme example being the September UK sovereign debt crisis: aside from a few specific factors, this was a reminder to everybody of the crucial importance of credible fiscal policies. In light of this market volatility, it is more important than ever that we protect customers. I would just like to say a word here on the increased transparency and justification of life insurance fees: in a speech to you alongside Jean-Paul Faugère, I called for progress to be made this year, with a particular focus on dialogue with insurers. Unfortunately, a satisfactory agreement has still not been reached: unless we can make progress rapidly in the industry, which is what we are still hoping for, we will, if necessary, adopt an ACPR recommendation by mid-2023. Jean-Paul Faugère will come back to this later.

Last, and most importantly, the return of uncertainty, and difficulties in anticipating risks. One risk is certain: the economic slowdown in Europe and more generally the world. The Banque de France does not anticipate a hard landing for the French economy; but we are collectively – and no doubt durably – having to face an "energy levy" of around 2% of GDP, which must be distributed equitably, including across businesses and households. Regarding financial stability, the number of incidents has multiplied over the last two years, especially in non-bank intermediation – I shall come back to this. For the time being, none of these events has had systemic consequences; but we need to be more vigilant on all levels as we cannot claim to know where the next crisis will come from, and we need to further strengthen our resilience. First by transposing Basel III and the Solvency II review into European law; then by enhancing our supervision of those risks that are still not sufficiently covered by the reforms.

II. Five questions on the French financial system

The first two seem clear to me and underline the French financial system's relatively favourable position in this new environment. The other are possibly more recent.

1. Is the financing of the economy still guaranteed? The answer is yes. For private individuals, housing loans in France are cheaper, more abundant, and safer than in all other major European economies. In a context of rising interest rates (estimated at an average of 1.84% excluding fees and insurance in November, compared with 1.12% in January), total outstanding housing loans were still 5.9% higher in October 2022 than a year earlier, and over 97% of these loans carry a fixed rate: this is a decisive advantage. For businesses, outstanding bank loans are rising sharply (up 8.6% in October): there has been a shift in the balance of corporate financing towards bank credit as the cost is more contained (rise of 85 basis points) than that of bond financing (up 350 basis points). Overall the real economy's financing needs remain largely covered, thanks to the work of the banks.

2. Are French banks and insurers solid? The answer again is yes, on several levels. French banks and insurers are in a solid financial and prudential position: the CET1 capital ratio of the six main banking groups is close to its all-time high (14.5% at end-September) and insurers'[1] solvency capital requirement coverage ratio increased in the first half of 2022 to 263%. Bank profitability should also gradually be boosted by the orderly rise in interest rates. In addition, as highlighted in an ACPR study, French insurers make little use of the types of derivative products that UK pension funds use. These factors explain why French banks' CDS premiums remain lower on average than those of banks in the United States, the United Kingdom and the rest of Europe.

At the European level, the banking authority – the EBA with the SSM – will carry out new stress tests in 2023 on the resilience of EU financial institutions. The underlying scenarios will need to be sufficiently severe and credible in the current environment of uncertainty and volatility. But we see nothing at present that justifies an industry-wide restriction on dividend payouts, such as that imposed temporarily in 2020. There is, however, a need for everyone to show prudence in terms of the future trajectory of capital, and in particular regarding share buybacks, which furthermore have to be explicitly authorised by the supervisor.

3. Are there any non-bank risks that could potentially trigger a crisis? The first area we need to pay close attention to is the less regulated players: while we have largely reinforced banks and insurers, we still have a long way to go on non-bank financial intermediaries (NBFIs). All episodes of financial instability in the last three years have been caused by the non-bank, non-insurance sector: from the money market fund "dash for cash" in March 2020 to UK pension funds in September. The vulnerabilities stem from excessive use of leverage, insufficiently controlled exposure to margin calls, or liquidity mismatch in open-ended funds which leaves them vulnerable to large and sudden capital outflows. It is high time therefore that we made progress on reinforcing the regulatory framework for NBFIs, both on a micro and macroprudential level. As an example, in the case of money market funds, in times of extreme liquidity stress, the competent authorities should be able to release liquidity buffers for funds that are in difficulty, but should also be able to activate appropriate liquidity management tools.

I would also like to draw your attention to three other non-bank risks:

- cyber risk, the frequency and cost of which are very likely to rise with the war in Ukraine. In the EU, the DORA regulation will come into force in 2025 and will at last provide a solid and common framework for making the financial sector more resilient to cyber attacks and for monitoring critical third parties such as cloud platforms.
- real estate markets, where housing prices had risen by close to 9% (year-on-year) in June 2022 in the euro area, much faster than household income. At this stage, the risks linked to a turn in the cycle are limited in France, thanks, among other things, to our macroprudential measures to make housing loan production sounder. We remain very vigilant, however, including with regard to the other segments of the market such as commercial real estate.
- crypto currencies, with the successive collapses, the most recent being FTX, that have triggered sharp market corrections and a "crypto winter" that has lasted for nearly a year: their recurrence shines a stark light on the need for stronger supervision. Yes, certain cryptos are probably on the way to becoming irrelevant.[2] But that does not mean we should lower our guard regarding the crucial need for regulation. France and Europe have led the way in this field, with the creation of the DASP status in 2019, then the adoption of the "Digital Finance" package including MiCA a few weeks ago at the European level. It is crucial now that these efforts be shared, especially by the United States.

4. What direction should macroprudential policy take? To guard against the risk of a turn in the credit cycle, the High Council for Financial Stability already announced in September that it would raise the credit protection reserve (called the countercyclical buffer) to 1%. In 2023, the economic slowdown calls for a balanced macroeconomic policy: it must protect, without being procyclical or restrictive, in a context of monetary tightening. This could mean "pausing" the countercyclical buffer at 1% – but not easing it. We will also keep the "structural" measures in place regarding lending conditions for housing loans; and we will remain very vigilant regarding the detection of systemic risks, especially in commercial real estate and the non-bank segment.

5. Should we postpone our efforts on climate risks in the short term? The climate transition is at risk of being overshadowed and delayed by the mounting financial risks and the energy crisis, with a temporary increase in the use of fossil fuels to replace Russian gas. Yet the climate risks we face have not subsided, far from it: if the climate transition is put off and carried out in a disorderly manner, the associated costs to our economies will be all the greater. The current context of uncertainty and volatility means that we should increase our vigilance regarding all risks, including those related to the climate, by making progress on the disclosure of climate-related information – which will become compulsory for European banks in 2023 under ESG Pillar 3 – and on how to operationalise transition plans and stress tests. On this latter issue, three European supervisory bodies will carry out an essential stress test in 2024 to assess in particular the transition risks to the entire financial sector linked to the implementation of the "fit-for-55" package.

The idea that we could make a short-term trade-off between climate risks and economic and financial risks is misleading: the two are unfortunately increasing in parallel, and, in the longer term, the Russian crisis is yet another reason for us to accelerate our energy diversification and sovereignty through the use of non-fossil sources. What we need then, over the next two to three years, is to chart a "path of compatibility": if we are to be consistent, any measures to support non-fossil fuels, on the supply or demand side – the famous "price shields" – must remain targeted and temporary.

I would like to conclude by coming back to Newton's experiment, where he split white light into the colours of the spectrum using a prism, and then recombined them using a second prism. After breaking the challenges of financial stability down into a spectrum of five questions – which are not exhaustive – I would like now to recombine them into a single certainty: we, as supervisors and regulators, we the ACPR, will do everything within our power to safeguard financial stability in the new macrofinancial landscape. I shall give the floor now to Dominique Laboureix: I would just like to congratulate him on his appointment as Chair of the European Single Resolution Board, and thank him warmly for his powerful work as Secretary General of the ACPR for the past three years.

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[1] Those subject to Solvency II.

[2] The ECB Blog, Bitcoin's last stand, 30 November 2022.