Bank of France Conference on
Financial Regulation – Stability versus Uniformity; A Focus on Non-Bank Actors
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PMH Panel Remarks

The New Regulatory Framework and Systemic Risk

I spent an important part of my life focusing on bank regulations, so I will start by talking about that and reacting to the observations of Professor Tirole and the other panellists; But equally when talking about systemic risk, the focus has shifted recently to non-banks, and rightly so, I will share a few thoughts on current debates surrounding asset managers and systemic risks.

As regards banking regulations, I strongly believe the time has come to reach a closure on the reform agenda.

That doesn't mean brandishing a "mission accomplished" banner. That would be premature.

But a lot of changes with profound implications for banks have been enacted, and the time has come to take stock. Moreover, there are a number of other sources of uncertainty in the global economy right now—the distortions caused by QE, which will have to be reversed at some stage, the upcoming end of the zero interest rate policy in the US and UK, the thorny rebalancing of the Chinese economy, disruptive technologies challenging centuries-old business models and so forth. All these sources of uncertainty compound each other.

So banks need a time-out to digest the reforms, adapt their practices and business models, and generally refocus on providing the best possible financial services to society rather than figuring out what they need to do in response to the latest regulatory change.

And regulators need a time-out to assess the impact of all the flurry of measures adopted since the Global Financial Crisis, both globally and internationally, and their interplay.

Once that assessment has been carried out, based on a sufficiently long observation period, then we can reconsider whether additional changes are needed.

To be completely frank, **I worry that the post-crisis regulatory rearmament, so to speak, has gone too far**.

- Let me be very clear, by that I don't mean levels of capital. In fact I am quite pleased to see that on that front the rules adopted globally have ended up being far more demanding than initially envisioned. When we raised the capital requirements in Switzerland in 2010, people thought we were crazy and competition would kill the banks. But in fact what happened was the opposite, namely a convergence to the top. And that is a very good outcome in my view.

- But alongside higher levels of capital, a long laundry list of additional requirements came to be added, and I worry this has switched the pendulum too far towards an interventionist model of regulation, which is both too burdensome and unlikely to solve every problem anyway. Back in 2008, when under the Chairmanship of Mario Draghi and guided also by Svein Andersen the FSF Working Group on Financial Sector

Resilience drew up a list for the G20 of necessary reforms, it was a long list to be sure, but most were related to capital.

- Of course, once it became clear that banks had not only taken excessive and poorly understood risks, but also engaged in criminal activities, it became inevitable that the regulatory agenda would seek to cover every nook and cranny of the banking business. Understandable, but, I fear, ineffective, and putting a huge compliance burden on banks, particularly those with global operations, who need to comply with as many variants of the same rules as there are regulators in the jurisdictions where they operate.

- Now, one might say maybe compliance burden is not something regulators should worry about too much if it serves a good purpose. But at the end of the day what matters is getting the incentives right. And at the current juncture my worry is that the net of regulations has become so complex that incentives are muddled and poorly understood. The goal is that banks fuel the economy in a sustainable way. They must be allowed to fulfil that function.

- And more generally the seemingly never-ending regulatory roadworks create considerable uncertainty for the banks and unwillingness to take even those risks that are a brick and mortar part of what makes banks an essential pillar of economic activity. There is right now a climate of fear in banks. As many of you know, I am not one to speak as an advocate of the banks, but I do not think that's helpful.

- So when I hear of Basel IV, when in Europe we have barely just begun harmonizing the actual implementation of a whole host of regulations deriving from Basel III, and miscellaneous initiatives that will in many cases require yet more capital, I become very concerned that this has gone too far. We desperately need well-managed banks for the economy to thrive, especially here in Europe where they provide such an overwhelming part of the financing to the economy, and will continue to do so even if the Capital Markets Union exceeds Jean-Claude Juncker's wildest hopes. Well-managed banks WILL NOT come from micro-management by the regulators but from robust incentives, mainly by way of adequate capital standards.

- Therefore, my suggestion would be to take a breather and focus on implementing sensibly what is there, above all capital requirements and resolution procedures; and assess the impact over a full business cycle. Then we will see if further changes are desirable.

Turning now to asset managers and systemic stability, I believe there are two issues on people's mind, which are often not well-understood in public debates. Let me offer my perspective

The first issue is SIFI designation, i.e., whether large asset managers should be considered Systemically Important Financial Institutions.

This issue was reviewed by the FSB earlier this year and it decided to put it off for the time being.And that was sensible because the FSB realized that it needed to undertake further analysis to fully understand potential financial stability issues associated with asset management *entities and activities*.

Let me stress this last point: *entities and activities*. Unlike banks, asset managers have tiny balance sheets, with hardly any leverage in them. That is true even of those that manage trillions of dollars of assets. Where the risks do potentially lie is in open-end funds and the activities they engage in, which can incorporate leverage and generally do involve maturity transformation, in the sense that asset owners are entitled to withdraw their funds on a possibly much shorter maturity than the securities the funds invest in can be liquidated.

That is obviously a risk. But the good news is that a large proportion of these funds are purely passive, i.e., they will merely follow whatever the index of reference is doing; and moreover, all these funds are run independently of one another, and rarely if ever come close to $100 bn—and this essentially by design, because capacity issues are reached when one approaches this threshold.

So it is conceivable that individual funds might run into a maturity mismatch and be forced to engage in fire sales in order to meet redemptions, particularly those that invest in less liquid assets and keep low cash buffers (according to recently published research, around a quarter of EM and HY bond funds hold less than 2% of cash buffer, when a wise benchmark is 5% even for more liquid assets); but it is hard to see how such individual events could in themselves pose systemic risk.

Of course if there is a sell-off in a given asset class, this could lead to systemic risk, but this would be because a myriad of asset owners independently decide they want out of that asset class. Whether their assets are pooled by an asset manager or managed directly is irrelevant to the outcome. (Put differently, a large institutional investor managing their assets themselves could be just as likely a trigger of a wide market move in such a scenario).

In sum, I am not at all saying there can't be systemic risks from asset management, but simply that more work is needed by the regulators to identify exactly where it might arise from and what to do about it. Stress tests, cash buffers, swing pricing rules are all conceivable components of the solution, but it is important to consider asset management activities in their entirety, whether outsourced or not, pooled or not.

The second issue is ETFs' potential to destabilize markets by facilitating herding and contributing to runs. ETFs are still relatively new in the investment landscape and as such not well understood, and they are growing very fast. From a regulator's standpoint, that is a dangerous combination. In reality, ETFs are a very useful innovation, that gives asset owners—whether retail or individual investors—inexpensive access to a wide array of assets that they would be set up to invest in otherwise, and with much greater liquidity than if investing via mutual funds.

This is because shares in ETFs can be bought and sold on exchanges at any time during market opening hours, and most of these transactions occur without need for actual selling (or buying) of the underlying assets. As a result, there is typically several times more turnover in ETF shares than in their underlying components. This is measurable liquidity.

At the same time, the price gaps encountered on August 24 in a number of US equities ETF revealed that when the market pricing mechanisms are impaired, the ETFs can momentarily become less liquid, and subject to wider price swings, than some of their underlying components. This is because when some of these components are suspended from trading or price quoting—

as happened on August 24 in application of the rules introduced in 2010 after the flash crash, the market makers who work behind the scenes to facilitate ETF transaction are unable to price the ETF. Hence the price gapping, which was also made worse by automatic stop-loss orders. So we are now focusing efforts on removing impediments to the flow of orders and pricing information for all traded securities. We are doing so in close collaboration with market-makers, since at the end of the day the goal is to minimize the occurrence of market conditions where they won't be able to perform their market making function.

Let me stop here for this round.