“Are the regulations implemented to guarantee financial stability compatible with the required acceleration in euro area growth?”

Speech by François Villeroy de Galhau,
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Dear Chairman,

Dear Permanent Secretary,

Dear Academicians,

Ladies and gentlemen,

It is an honour for me to speak before you this afternoon and I wish to warmly thank your Chairman Michel Pébereau for his kind invitation. We also have with us at this illustrious gathering some of my most renowned predecessors: Jacques de Larosière and Jean-Claude Trichet. I am very pleased that the topic you have chosen for this year is that of reforms. This term is often given too little prominence in France, between our supposed taste for revolutions and our actual conservatism. We have to turn to Alexis de Tocqueville in order to attempt to bring back the patience of enduring effort to our history: “[The French Revolution] took the world by surprise; yet it was the mere natural result of very long labours, the sudden and violent termination of a task which had successively engaged ten generations of men”.ii The example of our neighbours, from Germany to Spain, is today nevertheless illuminating in this respect: reforms work in Europe. They are the way, the only way, to make compatible our European social model, which is legitimate, and economic growth, which is essential in order to reduce unemployment and to finance our future.

Today, I will focus my talk on other no less important reforms, implemented in a particularly disrupted context: the financial regulations introduced in the wake of the 2007-2009 crisis. Is there any need to recall the disastrous consequences that this crisis inflicted on the real economy, the social dramas, and the democratic fragmentation with the rise of populism? Financial stability is therefore a common good that needs to be guaranteed. It is one of the three core tasks of the Banque de France, alongside monetary strategy and services to the economy. We have been striving to achieve it in the international bodies
that coordinated the financial reforms after the crisis. The urgency of the situation required rapid and effective action, and as early as April 2009, the G20 launched a global concerted action plan. This afternoon, I would like to start by explaining the ambivalent relationship between finance and growth, and the attendant need for financial regulation. Then, I will discuss at greater length what has been done, with an initial assessment of our achievements. Lastly, I will consider our challenges for the future.

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I. The ambivalent relationship between finance and growth.

I would like to say right away that finance is a remarkable instrument for economic progress, decisive in the birth of European and then global capitalism since the 16th century. In order to support trade initially, then investment, and innovation today, – as well as growth –, it is naturally vital to create the right conditions for financing the economy and for sound financial institutions.

Many academic studies confirm that finance makes a positive contribution to economic growth because it reduces transaction and information costs and leads to a better allocation of capital. It is estimated for example that between 1960 and 1995, some developing countries would have accelerated real per capita GDP growth by an additional 0.4 to 1 percentage point per year if their financial systems had been more developed. Some authors even go as far as positing that it would be preferable to let market forces prevail without worrying about the emergence of bubbles or financial imbalances which would be absorbed by themselves. This would mean that financial crises would just be the price to pay in the short term for stronger medium to long-term growth. The conclusions of these studies are nevertheless evidently too radical: they
place finance at the helm of the economy rather than an instrument at its service, an instrument used to achieve a goal, that of the work and progress of mankind.

Indeed, as with all human endeavours, **finance is not immune to certain excesses, or to certain limits**. Some studies have highlighted the inherent instability of the financial system. The existence of excessive risk-taking – the economists Guttentag and Herring use the concept of “disaster myopia” – or the possibility of bank runs are among the examples of market failures or negative externalities, which justify public intervention and financial regulation. Similarly, some indicators, which are initially signs of economic development, may in extreme cases reflect the over-exuberance of the financial system, which may hamper growth. For instance, it is commonly acknowledged that when volumes of debt as share of GDP are too high, this has a negative impact on growth in the long term. Beyond public debt – discussed in a report by your Chairman in 2005, and alas still topical – private debt in France now stands at 130% in France, compared with 122% in the euro area and 150% in the United States.

Regulation can and must play a protective role, by setting certain limits ex post and by shoring up resilience to destabilising impacts ex ante. A 21st century Rabelais would say that finance without conscience is but the ruin of the soul. I will return to individual conscience in my conclusion. But undoubtedly, finance without rules could be the ruin of the economy.

To be sure, financial regulation is necessary particularly because **financial crises often have considerable economic and social costs**, with serious and lasting repercussions. A study by Laeven and Valencia in 2013, which considers 147 banking crises between 1970 and 2011, estimates the median output loss between the peak of activity before the crisis and the three years after at around 23% of GDP, and the median increase in public debt over the same period at 12% of GDP, while total government bailout spending amounts
to almost 7 percentage points of GDP. Moreover, beyond the immediate effects, financial crises reduce the economy’s long-term potential: companies cut back on their R&D, capital and infrastructure investment, which results in a decline in productivity and a slowdown in technological progress.

The 2007-2009 crisis is unfortunately an illustration of this; it was the worst crisis since that of the 1930s. The financial imbalances generated by the bursting of the subprime bubble in the United States spread rapidly to the global economy. The crisis affected both the level and trend of GDP, leading to a permanent loss in wealth. Cumulative GDP losses compared to the pre-crisis trend are estimated at a quarter of global GDP. In a number of countries, in particular in southern Europe, GDP has still not returned to its pre-crisis level.

II. The new regulations have increased the solidity of the financial sector, without weighing to any notable extent on economic growth.

The exorbitant costs of the 2007-2009 crisis highlighted the urgent need to reinforce financial stability, and the response was unequivocal. In 2009, at their meetings in London and then Pittsburgh, the G20 leaders rose to the challenge of their historical mission, setting an ambitious agenda for global cooperation. The opening words of the communiqué from the London summit still merit repeating today: "A global crisis requires a global solution […]. We believe that the only sure foundation for sustainable globalisation and rising prosperity for all is an open world economy based on market principles, effective regulation and strong global institutions. We have today therefore pledged to do whatever is necessary to: restore confidence, growth and jobs; repair the financial system to restore lending; strengthen financial regulation to rebuild trust."
This **unprecedented regulatory effort** concerned all financial system participants. Four main objectives were set: (i) to make financial institutions more "resilient", that is increase their soundness and their ability to withstand crises; (ii) to put an end to the problem of "too-big-to-fail" institutions – which benefited from an implicit guarantee that they would be bailed out by the government; (iii) to make over-the-counter derivatives markets more secure, notably through central clearing; and (iv) to transform unregulated market activities – shadow banking – into a sound form of market financing. At the global level, responsibility for the operational implementation of these objectives was entrusted to the Financial Stability Board, and to the Basel Committee on which both the Banque de France and ACPR are active.

Since 2010, significant, albeit uneven, progress has been made on all four G20 objectives. I shall focus here on the first of these: financial institutions are now more resilient. The Basel III Accords, adopted in 2010, have increased both the quantity and quality of banking sector **own funds**; in addition, they ensure better account is now taken of the diverse risks to which banks are exposed, thanks to the introduction of a leverage ratio – measured as a share of total unweighted assets – and two new **liquidity ratios** for bank cash levels. Requirements have also been increased in the **insurance sector**, with the entry into force of the new Solvency II regulatory framework in Europe at the start of 2016. At the end of 2016, French insurance firms subject to Solvency II had a solvency capital ratio of 222%, well in excess of the required 100%. These various tools, known as microprudential as they are intended to reduce the individual risks incurred by financial institutions, have been supplemented with a set of so-called **macroprudential** tools, designed to improve the stability of the financial system as a whole. In France, the development of macroprudential policy led to the creation, under the 2013 Banking Law, of the High Council for Financial stability (HCSF), chaired by the Minister for Finance, and on which the Banque de France plays an active role. This High Council meets once a quarter with a total of eight members, three of whom are
independent economists. It identifies any risks of potential financial "bubbles", and has the power, where necessary, to implement a series of macroprudential measures, including a countercyclical capital buffer – currently set at 0% – or tighter lending standards.

Ten years after the start of the crisis, eight years after London and Pittsburgh, it's time now to stand back and take stock. Our achievement today is that the objective has largely been met. The first assessments show that these reforms have had a significantly positive impact on the soundness of banks, both in terms of their ability to withstand liquidity shocks and their solvency, with the core capital ratio (Common Equity Tier 1 or CET1) of the main banks operating at international level rising by 5 percentage points since 2011, from 7.4% at end-2011 to 12.3% at end-2016. As for the four largest French banks, their own funds have more than doubled since the crisis: in 2008 they amounted to EUR 132 billion; in 2016 that figure reached EUR 296 billion. Put another way, the majority of French banks have increased their capital levels by more in the past eight years than in the previous century.

This increase in financial institution resilience has not been achieved at the expense of economic activity. This brings me to the crux of the question put to me by your Academy today. First, the objective of the regulators was clearly to limit the potential adverse effects of their reforms on the real economy, and to ensure that financial activities support growth and economic development. In 2010, before the roll-out of Basel III, major work was carried out to measure the impact of these reforms. The Basel Committee’s Macroeconomic Assessment Group concluded, from a broad range of estimates, that for every 1 percentage point rise in the target capital ratio, the cost of credit would increase by an average of around 0.15 percentage point. Yet in practice, this credit tightening never materialised. The favourable effects of the fall in interest rates under the accommodative monetary policy stance
have far outweighed any negative consequences of stricter regulatory requirements. Today in Europe, as in France, the flow of bank lending to businesses and households remains robust. Indeed, the strength in private sector lending is even the focus of particular vigilance in France and on the part of the HCSF. In September 2017, growth in bank lending to households and businesses reached 5.7% and 5.4% respectively in France, twice the rates observed in the euro area as a whole. Since the start of 2010, the cumulative growth in both forms of lending (29%) is almost twice that of nominal GDP. No one can seriously argue that the financial reforms have, up to now, restricted the credit supply, and hence growth, in France. At the same time, it should be stressed that the French banking system – one of the most resilient in Europe and the world – has fulfilled its role in financing the economy. Beyond the French banking sector, the Financial Stability Board has also noted an improvement in the resilience of all financial institutions at global level, with no decline in the provision of financing to the real economy.\textsuperscript{xiv}

I'd just like to say a few words on what seems to me to be a false debate. Although the recovery has indeed been slower in Europe than in other geographical regions, this cannot be attributed to overregulation. The scale of the euro area’s difficulties can in part be explained by the fall-out from the debt crisis which has affected its members since the start of the 2010s. In addition, certain more specifically European or French problems, such as the slowdown in productivity or the lack of sufficient structural reforms, are also limiting the acceleration in growth. Lastly, for the time being at least, the regulations have, on the whole, been applied at least to the same extent in the United States as in Europe.

III. \textbf{Five challenges for a balanced regulatory framework.}
That said, I will be careful not to be utopian about these new regulations. We are still faced with **five challenges** and if I may, I would like to consider each of them in turn.

1) The first challenge is to **complete the rules for banks' minimum capital requirements by finalising the Basel III reform**. The majority of the work – let's say 80% – has already been done: its main aspects were approved in 2010-2011 and are now widely implemented. However, discussions remain ongoing on the question of risk weighting in bank balance sheets. The goal is to limit any unjustified variability in the weighting between banks or countries. However, this must not result in a standardisation, as the variability of results is also a reflection of different risk profiles. The risk sensitivity allowed for in banks' internal models represents a huge step forward, as it ensures that requirements are proportionate to risk-taking. Naturally, we must reinforce confidence in internal models by supervising them closely, as the ACPR has long done and as the Single Supervisory Mechanism in Frankfurt does today. But the task at hand is to finalise Basel III, not to build a new Basel IV based mainly on the standard approach that by definition would not take account of differences between countries and banks.

It is in the strategic interests of France, which has always promoted international rules, to conclude a final agreement on Basel III. We have made significant progress, particularly during the latest Basel Committee meeting last month on 4 and 5 October, but we are not there yet, even though I hope that an agreement will be reached as quickly as possible. If we are to reach an agreement, two conditions must be met. First, the agreement must be **fair** – it must be applied by all jurisdictions, in all its components, including by the Americans in the measurement of market risks, i.e. the “fundamental review of the trading book” (FRTB). Second, the agreement must be **reasonable**, in terms of the increased capital requirements that will apply to French and
European banks – including through the introduction of the so-called "output floor" on capital requirements for banks that use internal models. On the one hand, these capital requirements would have to be met over time through "normal" allocations of profits to reserves, without any bank having to resort to a dedicated capital increase. On the other hand, these new rules must be fully compatible with the smooth financing of the French and European economy and sound credit growth. In particular, our mortgage lending model, based on guaranteed loans, and our financing of SMEs cannot be called into question. In my view, these are the principles that will determine whether any future agreement can be accepted.

2) The second challenge is to **finalise measures that target non-banks**. First, progress must continue on the "resolution" of central counterparties – their treatment in the event of difficulties –, as they have become systemically more important with compulsory centralised clearing for derivative instruments. Above all, we must ensure a balance between financing channels. All discussions on the shadow banking system must continue in order to take account of the risks that may have moved into this sector as a result of the ramping up of requirements in the regulated sector, and for banks and insurers in particular. It has been estimated that the segments that may pose financial stability risks represented a total of USD 34 trillion.\(^{xv}\) The priority has now shifted from the solvency of banks, which has improved substantially, to the liquidity of the shadow banking sector, particularly funds and asset management companies that are exposed to the risks of sudden panic-driven runs. Lastly, progress is required on FinTechs and above all on the major digital platforms and businesses, which, if they carry out financial activities, will have to comply with similar regulations sooner or later.

3) The third challenge is **evaluation**. Evaluation is essential to the credibility of the financial reforms that have been adopted worldwide, and to this end, the
G20 adopted a post-implementation evaluation framework this summer. This framework should allow us to determine whether the reforms have actually achieved their desired results, without any unexpected, adverse effects, and to make adjustments if this is not the case. Two initial evaluations are already underway: the first deals with the effectiveness of reforms that encourage the use of central clearing while the second assesses the impact of G20 reforms on access to financing, which will begin by looking at infrastructure financing before focusing on credit to small and medium-sized enterprises (SMEs). The first evaluation reports are expected to be made public by the end of 2018.

4) The fourth challenge, in order to consolidate the progress we have made, is to ensure that the new regulatory framework is implemented consistently across the board while remaining vigilant to avoid backtracking. In *The Country Doctor*, Balzac wrote "...in all things human, is not constancy the highest expression of strength?", rightly reserving this virtue for the great men of his day. Now, as you know, the new US government has raised the possibility of reviewing their national banking regulations. Certain national adjustments could be considered appropriate and justified, as is the case, for example, for regulations that concern entities whose operations are only local in scale, or regulations that are purely American in scope such as the Volcker rule on proprietary trading portfolios. But the same cannot be said for abandoning the minimum requirements agreed internationally that apply to entities operating on a global scale, like the FRTB that I mentioned previously. Unilateral deregulation would be nothing less than a lose-lose scenario with serious consequences for the stability of the global financial system – we would be paving the way for the next financial crisis – as well as the competitive landscape for US and European banks. International cooperation on financial reforms is a common good that has been extremely precious during these past eight years and is crucial to our future.
5) The fifth challenge is to **complete the European framework and ensure greater consistency between regulation, supervision and resolution.** Since 2014, the euro area has taken decisive steps with its Banking Union, which now ensures the uniform supervision of the banks of 19 countries. But in order to complete it, further progress is needed on three levels. First, with regard to concrete mechanisms, the second pillar of the Banking Union, which deals with "resolution" in the event of difficulty, must be finalised and simplified. Second, laws and requirements, which all too often accumulate diverse additional regulations and amendments, should be coordinated in a consistent manner. Moreover, cross-border banking mergers in Europe are still too difficult. Lastly, as regards the interaction between institutions, we should develop a better interaction between the various European authorities, and even envisage, going forward, a single authority that would strive to enhance the soundness of the European banking sector. And in addition to the regulatory aspect, we must endeavour to implement what I call the Financing Union for Investment and Innovation. The goal is to better channel the euro area savings surplus of EUR 350 billion to the areas where investment is needed, and encourage the pooling of private risks, particularly through the development of corporate equity.

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I would like to conclude by mentioning a sixth and final challenge: the inherent **limitations** of any regulation, no matter how worthy it may be. First, financial stability is not simply a question of regulation; it rests on a trifecta of regulation, microprudential supervision and macroprudential policies, and relies on each of these components in equal measure. What's more, and above all, there must be complementarity between collective rules and individual behaviour – ethics. Prior to 2007, self-regulation was the norm, especially in Anglo-Saxon countries, placing excessive trust in codes of conduct and business ethics. Today, let's make sure we don't tip the scales too much in the other direction.
The Académie des sciences morales et politiques is here to remind us that rules will never be a substitute for individual conscience. This also applies to the financial sector. Thank you for your attention.

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2 Alexis de Tocqueville, *The Old Regime and the Revolution*, Book I, Chapter V.
15 xix See reports by the Basel Committee’s Macroeconomic Assessment Group (MAG) and Long term Economic Impact Group (LEI).