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Basel III: an assessment, an outlook

Our meeting tonight could not be more timely: we are now in a pivotal period for the Basel III reforms, eight days after the meeting of the Basel Committee in Chile, one month before the decisive meeting of the GHOS (Group of Governors and Heads of Supervision). We started to write this new page of banking regulation very soon after the financial crisis. Eight years have passed since the Lehman crisis. It is high time to put an end to this regulatory chapter, to focus on implementation and supervision, and to give stability and predictability to the financial industry and thereby to the economy. But before laying out the prospects for the coming weeks - which is what you probably expect from me tonight - it is necessary to take stock of the measures of the Basel III package that have already been adopted: the results are considerable, and positive.

- **Basel III reforms were absolutely essential after the crisis**

No one, I hope, can seriously dispute - even among the banking industry, including on the other side of the Atlantic - that after the financial crisis it was necessary to significantly strengthen regulation to reduce risks. The financial crisis has had heavy economic and fiscal costs, as well as social costs through the drama of unemployment. Its political consequences for our democracies are still visible today. We must all wish and act for a better prevention of future risks: it is a collective imperative. Remarkable achievements have been carried out since 2009 under the impetus of the G20 and the Financial Stability Board. Basel III is a very comprehensive reform that has significantly strengthened the prudential system for banks and financial stability [slide 2]. Beyond the very last measures of the Basel III package still under discussion, great progress has already been made:

- First, by raising capital requirements, Basel III has made the financial system much stronger than before the crisis. Banks now have more capital and of higher quality. [slide 3] To take the example of France, major banking groups more than doubled their core tier 1 capital between 2008 and 2015, from a total of EUR 132 billion to EUR 275 billion. The improvement in solvency was mainly achieved through the increase in capital, rather than through the reduction in average weighted assets – i.e. financing to the economy.
- Also, Basel III broadened banking regulation beyond the solvency ratios to take into account the diversity of risks to which banks are exposed. A leverage ratio - relative to the unweighted balance sheet total - was introduced. Two new liquidity ratios also complement the regulatory framework: the LCR (Liquidity Coverage Ratio) covers short-term liquidity, the NSFR (Net Stable Funding Ratio) controls the refinancing structure. French banks have already adjusted [slide 4]: they have almost doubled their liquidity reserves since 2011 and now largely meet the LCR requirement, which will only be fully binding in 2018.
- Lastly, Basel III makes it possible to respond more effectively to financial stability issues by providing dedicated tools, such as countercyclical capital buffers, or for systemically important banks. In 2013, France set up the *Haut Conseil de stabilité financière* (HCSF - High Council for Financial Stability), which is qualified to take macroprudential measures; the HCSF has its European equivalent with the ESRB (European Systemic Risk Board). And the new European Single Resolution Mechanism (SRM) is now fully in force.

A question is nevertheless often raised: what is the economic impact of these new rules? Are they likely to overly constrain the financing of the economy and hence to weigh on growth? I believe it would be desirable that, over time, we set up instruments for conducting an ex post assessment of these economic effects: the Financial Stability Board is working on this issue, on the basis of a plurality of methods and including the benefits derived from a lower probability of crises occurring. We discussed this at our meeting in London on 17 November. However, today no one can seriously claim that the supply of credit in France or in Europe is constrained by prudential ratios. There has been no rise in the cost of credit, quite the contrary, and growth of credit to the economy is particularly robust in France, at + 4.6% for loans to businesses and + 4.1% for households in October 2016 [slide 5]. The Eurosystem's accommodative monetary policy has certainly contributed to this by fostering excess liquidity for European banks. For the future, however, the question may arise. We must absolutely avoid this pitfall in the finalisation phase of the Basel III reforms.

- **As the final pieces of the Basel III framework are put in place, we must keep in mind the need to safeguard financial security and the ability of Europe's banks to finance the real economy**

Basel III is nearing completion. The last remaining work areas chiefly concern the measurement of risk on bank balance sheets. Beyond the technical questions raised, two key challenges have to be met.

First comes the question of how **internal models** fit into the prudential risk assessment framework. On this issue, we should not aim at the wrong target. It is certainly important to limit the variability of results between banks and across countries, but only if this variability is unjustified. Several papers have stressed the differences between European and US banks. In particular, the latter have on average higher risk-weighted assets (RWAs) as a percentage of total unweighted assets – what we call density. Yet we must steer clear of drawing simplistic conclusions [slide 6]. The variations observed between Europe and the United States are not due to the sole use of internal models rather than the standardised approach. We also have to consider the very different nature of bank balance sheets in the two zones, notably owing to more widespread use of securitisation – of real estate loans especially – and market financing in the US, not to mention differences in accounting rules. Naturally, we must reinforce confidence in internal models by supervising them closely – a task long performed by the *Autorité de contrôle prudentiel et de résolution* (ACPR) and more recently taken on as well by the Single Supervisory Mechanism in Frankfurt – but this need not be at the cost of full-blown standardisation. Risk sensitivity must be maintained because it represents a huge step forward with Basel III, ensuring that requirements are proportionate to risk taking. You can see [slide 6-3] that the correlation between RWAs and the cost of risk is high in Europe as well, confirming that different risk profiles are largely responsible for the difference in RWAs between geographical zones. In other words, the task at hand is to finalise Basel III, not to build a new Basel IV, a notion that has been widely decried in some quarters.

The second challenge involves the **impact** of the new prudential rules and, ultimately, their effectiveness in achieving the stated goals. Systematically strengthening capital is no longer the aim, since the requisite adjustments in this area have, as I said, mostly been carried out. A further across-the-board increase is unwarranted from a financial stability perspective and might interfere with orderly financing of the economy, especially in Europe, where bank intermediation plays such a crucial role in the economy. Admittedly, capital requirements could go up at some banks as a result of adjustments to the parameters of their internal models, when justified. We must also bear in mind that some measures aimed at bolstering the prudential framework were adopted recently and have yet to be implemented – I am thinking particularly of the fundamental review of the trading book, that is, of the treatment of market risk.

G20 leaders have repeatedly underlined the general objective of refining the Basel III framework “without further significantly increasing overall capital requirements”. They reaffirmed this stance in Shanghai in February, in Washington in April, and again in Hangzhou in September. The Basel Committee must, of course, comply with the mandate entrusted to it.

The initial proposals published by the Basel Committee in the first half of 2016 fell short in terms of meeting these two challenges, as I underlined at that time. Their impact was excessive and they raised technical issues on several fronts. But considerable progress has been made, both since the summer and at the Santiago meeting. To achieve this took unwavering determination on the part of the French negotiating team, a strong cohesion within the euro area, particularly between France and Germany, and substantial expert work by ACPR and Banque de France staff, to whom I extend my congratulations.

We have not yet reached an agreement. But the possible outlines of the final Basel III reform are becoming clearer. Among other things, they include:

- Risk sensitivity is to be maintained, with certain portfolios remaining eligible for internal models. Additionally, a number of excessive technical parameters were removed at the last Basel Committee meeting, both for credit risk and operational risk.
- Guaranteed loans will be considered equivalent to mortgage loans. This is a major advance for French banks and should lower the requirements on these portfolios. This will reinforce, not threaten, real estate lending in France.

Even so, we are not yet at the end of the process:

- Numerous details still have to be clarified, and appropriate treatment of specialised financing (for equipment and large-scale projects) needs to be secured for the long term.
- The debate is still lively over the principle and calibration of an output floor – i.e. the potential introduction of a capital floor for internal models, calculated as a percentage of the standardised approach.

The Banque de France and the ACPR will remain vigilant until the work with our European partners is completed. And should an agreement be reached, its future transposition in Europe would obviously be dependent on compliance by other major geographical zones, including the United States and its incoming administration.

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I would like to end by sharing my belief with you. Provided that it is balanced, a final agreement on Basel III is in everyone’s interest. Banks, first of all, need to see an end to the regulatory uncertainty that is weighing on their strategy and depressing their market valuations. Companies and households will also benefit by being able to count on stable financing. And it is in the interest of France and Europe to maintain shared rules at a global level that will help to ensure an orderly international financial system and fair treatment of all participants. While it is still too early to say with certainty, for some important points still remain outstanding, I am nevertheless more confident that we will be able to reach this decisive agreement by the beginning of next year. Thank you for your attention.