# Towards financial stability: a common good that needs to be consolidated and reinforced

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In the immediate aftermath of the crisis, at the London Summit in April 2009, the G20 heads of state and government got together to launch a concerted global action plan. Their joint aim was to address the flaws in the existing regulatory framework, which had proved incapable of preventing imbalances from building up in the financial system and from spilling over to the real economy. Eight years later, with most of the elements in this plan now being finalised, concerns are being raised as to the potential negative effects of the new regulations, with some even questioning the need for robust global regulations to safeguard financial stability.

In order to contribute to the debate and provide some factual enlightenment, the Banque de France has chosen, for its 2017 *Financial Stability Review*, to bring together the views of public authorities, academics and industry representatives. With the benefit of a few years' hindsight, and based on the results of various assessment exercises, the contributions point to both an achievement and a challenge. The achievement is that the regulatory reforms put in place since the crisis have made the global financial system substantially more resilient, with no noticeable adverse impact on growth. The challenge now is to finalise the regulatory framework and guarantee its long-term sustainability.

## 1| What we have achieved: the action plan agreed by the G20 has largely met its objective without weighing to any noticeable extent on economic growth

**The 2008 crisis exposed the urgent need to reinforce financial stability, and prompted a swift and resolute response on the part of public authorities.** The financial crisis had a huge impact on the real economy: many countries have still not seen a return to pre-crisis levels of output and are suffering from high levels of unemployment, while the cost of bank bailouts to public finances continues to weigh on growth. The cumulative loss of output since the crisis, compared to its pre-crisis trend, is of the order of 25% of one year's world GDP.[1] To prevent a repeat of the turmoil, considerable efforts have been made at international level since 2008. The members of the G20 have significantly reinforced the regulatory framework, starting with prudential standards for banks under Basel III, and then gradually extending their scope of intervention to other areas and sectors: the centralised clearing of over-the-counter derivatives, the resolution of systemically important banks, the regulation of the shadow banking system and of credit rating agencies, and the development of macroprudential policy.

**These unprecedented regulatory reforms, coordinated globally, constitute an essential achievement and a shared foundation that must be preserved in all G20 jurisdictions.** On the whole, the standards agreed at global level have been implemented in a timely and consistent manner by all G20 members, as evidenced by the findings of the Financial Stability Board's (FSB) annual country peer reviews. The impact of the reforms on the resilience of the financial system has been very largely positive. Banks in particular are in a much stronger position, both in terms of their ability to withstand liquidity shocks and their solvency: the core equity (CET1) ratio of the largest banks operating at international level has been raised from 7.1% in mid-2011 to 11.9% in mid-2016.[2]

**Various studies have been carried out to measure the impact of the reforms on the financing of**

1 See *IMF World Economic Outlook*, April 2015; Ollivaud (P.) and Turner (D.), *The effect of the global financial crisis on OECD potential output*, OECD *Working Papers*, No. 1166, 2014.

2 BCBS, *Basel III Monitoring Report*, February 2017. Data for Group 1 banks.

**the economy and on growth.** The most extensive were those conducted by the Basel Committee's Macroeconomic Assessment Group (MAG)[3] in 2010, before the introduction of the Basel III reform, and which used 97 models and simulation tools to examine the effects of the regulatory transition. These were complemented by the work of the Long-term Economic Impact group (LEI),[4] which measured the long-run effects of the reforms on economic growth. The MAG concluded, from a broad range of estimates, that the median increase in the cost of credit in response to a 1 percentage point rise in the target capital ratio would be roughly 15 basis points. But in actual fact, this impact never materialised. Indeed, the favourable effects of the interest rate cuts under the accommodative monetary policy stance have far outweighed the feared negative consequences of stricter regulatory requirements. Since then, other studies have been conducted by the financial industry itself, by academics, central banks and international and European organisations. The debate is clearly a complex one, and results may vary depending on the particular methodology used. Nevertheless, what largely emerges from these analyses is that the new bank prudential regulations have been implemented with no noticeable impact on global economic growth and without creating any major conflicts between the objectives of financial stability on the one hand and the financing of the economy on the other. I stand firm in my belief: no one can seriously claim, either in France or in Europe, or indeed in any advanced economy, that the credit supply has been excessively impaired by bank regulations. Outside the banking sector, the FSB notes that the resilience of all financial institutions has been improved, with no decline in the overall provision of financing to the real economy.[5] And although it highlights three areas warranting vigilance – market liquidity, the effect of reforms on emerging market and developing economies and the risk of financial market fragmentation – which may justify making minor adjustments to the final calibration of the rules under the planned regular reviews, this in no way detracts from the overall balance of the reforms.

## 2| The challenge for tomorrow: to consolidate and complete this achievement while ensuring the long-term sustainability of the new regulatory framework

**The priority today, nearly ten years after the crisis, is to finalise the work in progress in order to stabilise the regulatory framework for both the bank and non-bank sectors.**

**With regard to the banking sector first,** the main concern now is to complete the Basel III framework, and not to put together some hypothetical Basel IV reform. As reiterated by the G20 heads of state at the Hangzhou Summit in September 2016, Basel III should be finalised without significantly increasing overall capital requirements. The main elements of the package have already been approved at international level and have largely entered into force in most G20 jurisdictions, notably the standardisation and significant reinforcement of capital, the introduction of a leverage ratio, new liquidity ratios and macroprudential capital buffers, and the reform of bank trading books. The remaining work underway relates essentially to the measurement of risk in bank balance sheets. In this respect, the Basel Committee has made significant efforts over the past few years to simplify and improve the comparability of risk-weighted assets across institutions and jurisdictions, in order to reduce unjustified variations in results. The Group of Governors and Heads of Supervision (GHOS), which is endorsing the banking sector regulatory reforms at the international level, has not yet reached an agreement on key aspects, notably the framework for the use of internal models: setting the capital floor too high would discourage the use of internal models and lead to an excessive reduction in the risk sensitivity of the regulatory framework. However, France, Europe and Japan are all keen to ensure that the use of detailed models – subject to approval and oversight by the supervisory authorities – remains at the heart of bank risk monitoring. It is essential, therefore,

3 MAG, BCBS, *Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements*, December 2010.

4 LEI, BCBS, *An assessment of the long term economic impact of stronger capital and liquidity requirements*, August 2010.

5 FSB, *Implementation and Effects of the G20 Financial Regulatory Reforms*, 31 August 2016, 2nd Annual Report.

that we continue to work towards an agreement. Now, almost a decade after the crisis, the banking industry and its clients need finally to be able to operate in a stable regulatory environment.

At the European level, the main challenges for the finalisation of banking regulations relate in particular to **resolution**: the November 2015 Antalya agreement set out the new international total loss-absorbing capacity requirement (the TLAC ratio) for systemically important banks, and it is important to make this consistent with the European minimum requirement for own funds and eligible liabilities (MREL ratio). The proposals put forward by the European Commission last November are a step in the right direction. Inspired by the French system set out in the so-called "Sapin II" law, the measures introduce a new category of senior non-preferred debt which enables banks to comply with the TLAC standard, but without imposing excessive constraints on their financing structure or forcing them to modify existing contracts.

**With regard to the other sectors of the financial industry, i.e. the "non-banks"**, major work has been started under the aegis of the FSB, and this should be carried forward. At this stage, in my view, the situation for the insurance sector is satisfactory, particularly in the European Union where the new Solvency II regulation recently came into force. However, work on asset management activities and on the resolution of central counterparties (CCPs) needs to be actively continued: this should be the main priority, in response to concerns over shadow banking. The FSB has already published its recommendations on **asset management** and we now need to ensure that they are effectively implemented. And a last major piece in the supervisory framework will be the application of resilience tests to measure funds' ability to withstand liquidity shocks to the entire financial system. With regard to **CCPs**, which have been made even more systemically important with the introduction of mandatory central clearing for standardised over-the-counter financial instruments, the European Commission published a draft regulation at the end of last year on their recovery and resolution; meanwhile, the FSB is working on proposed guidance that would apply at the global level. Given the closeness of the links between CCPs and their participants throughout the world, and not just in Europe, the European proposal has developed an approach that is very much consistent with the international guidance. This alignment should be both preserved and deepened over the long term.

**In the longer term, ensuring the sustainability of the regulatory framework will mean striking a balance on two levels: between growth and financial stability on the one hand, and between ending "too-big-to-fail" and encouraging European cross-border consolidations on the other.**

One criticism frequently put forward is that there is a fundamental conflict between the objectives of **economic growth and financial stability**. However, this argument does not stand up to long-term analysis. It is in nobody's interest to foster unstable growth that leads ultimately to a financial crisis; conversely, any excessive curtailment of the credit supply that hampered growth would undermine the very objective of financial stability. Ensuring that financial stability remains compatible with growth over the long term will first mean conducting regular and reliable assessments of the reforms put in place. To this end, the authorities will need to equip themselves with tools capable of covering the full range of measures and of capturing their cumulative effects. Germany has rightly made developing such a toolbox a priority for its G20 presidency, and indeed collective endeavours in this area are to be encouraged. Building on the work of the MAG in 2010, a periodical review should be introduced to systematically evaluate planned rules and their economic impacts ex ante, and analyse them comprehensively ex post. In parallel, authorities should take maximum advantage of review clauses, which enable them to adjust the existing regulatory framework as much as needed.

Another point that warrants attention relates in particular to the European Union, where we need to find the right trade-off between monitoring systemically important (too-big-to-fail) institutions and the need to increase European financial integration. The construction of the European Banking Union is now almost finished. Its first pillar, the Single Supervisory Mechanism, is already in place, while the second, the Single Resolution Board, is well on the way to completion. Together, they provide a solid framework to ensure that the welcome consolidation of the European banking sector takes place in an orderly and sound manner. In anticipation of the creation of a genuine "Financing Union for Investment and Innovation", **cross-border bank consolidations** would help to channel savings more effectively towards investment and improve the sharing of risks. The banking sector in the United States is much more concentrated today than the European Banking Union.

## 3| Conclusion

Financial stability is a common good, but it is a fragile one and therefore all the more precious. In this respect, the banking and financial regulations adopted since the crisis are a major asset that needs to be preserved, as they have helped to stabilise the global financial system and make it more secure. Any temptation to go back on this or to massively deregulate would increase the risk of another financial crisis. The challenge now is to consolidate and reinforce these achievements; hence the importance of carrying out regular impact assessments. The attitude of the new US administration will, of course, be key: now more than ever, close international coordination and strong political determination are vital.