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William C Dudley: Lessons from the financial crisis

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Economic Club of New York, New York City, 6 November 2017.

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It is a pleasure to have the opportunity today to speak again at the Economic Club of New York. As we mark the tenth anniversary of the onset of the financial crisis, I would like to focus on some of the lessons we should draw from that harrowing experience, and the implications of those lessons for regulatory policy going forward. As always, what I have to say reflects my own views and opinions and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.

The first lesson is that financial crises can have grave consequences—for the economy and the nation—that can linger for many years. The toll from the financial crisis was severe, with nine million jobs lost and eight million housing foreclosures amid the deepest economic downturn since the Great Depression. Moreover, the road back has been long and slow. Despite economic policies oriented toward supporting recovery, it has taken eight years to push the unemployment rate down to a level consistent with the Federal Reserve's employment objective. Other residual impacts include the large size of the Federal Reserve's balance sheet; significantly higher public debt; and substantial damage to public trust in the nation's government and financial institutions.

The second lesson follows from the first. We need to ensure that we have a resilient financial system. To that end, we must ensure that the safeguards put in place in response to the crisis are fully appreciated and respected. But, it also means that we need to finish the job—for example, by building out a fully workable regime for resolving a complex, global firm if one were to become insolvent. We need to ensure that our financial system can continue to provide critical services not just during good times, but also during periods of stress.

These objectives are particularly relevant today, when reopening the Dodd-Frank Act and modifying our regulatory framework are under consideration. While it is appropriate to evaluate adjustments that might improve our regulatory regime, it is critical that we do not forget the hard- learned lessons of the crisis and—in the haste to reverse course—undermine the robustness and resiliency of the financial system.

The U.S. housing market boom and bust

At the heart of the crisis was the U.S. housing boom and bust. Between 1997 and 2006, U.S. home prices nearly doubled in real terms on a national basis. Then, when the boom turned to bust, real home prices reversed course, declining by about 40 percent on a national basis, with larger price declines in several states. [1] The magnitude of the national price declines was unprecedented during the postwar period.

The evolution of the financial crisis illustrates a number of key issues, including the potential hazards of financial innovation, the procyclicality of the financial system, and the importance of confidence in sustaining effective financial intermediation.

The housing boom resulted from several factors. Innovations in subprime mortgage lending enabled moderate-income households to purchase homes with negligible down payments. This led to an increase in the demand for housing, which helped push up home prices. Home price appreciation masked the potential riskiness of such lending and, in turn, sustained the wisdom of the easier underwriting standards. As long as home values were rising, subprime borrowers could either refinance their loans or sell their homes when the initial teaser rates expired. Thus, losses on subprime and other mortgage lending were low, reinforcing the belief that such loans were “safe.”

Easier mortgage underwriting practices were also supported by the ability of mortgage originators to pool their mortgages into collateralized debt obligations (CDOs), transforming low- quality assets into triple-A-rated securities. Investors, including banks, relied too heavily on credit ratings and didn’t do sufficient due diligence on the underlying quality of the assets and the assumptions that underpinned the triple-A ratings. Implicit in these ratings was the assumption that a large, national decline in home prices was extraordinarily unlikely.

The rise in home prices led to a surge in construction activity, which helped to sustain the housing boom for a time. This effect was particularly powerful in states such as Arizona, California, Florida, and Nevada. Rising home prices also bolstered the economy by supporting consumption, as households monetized these gains by cash-out refinancings and home equity lines of credit.

The housing boom was also supported by an accompanying financial boom. The financing activity associated with the surge in mortgage originations and securitizations pushed up the earnings of the major banking and securities firms. These strong earnings created incentives to ease underwriting standards further.

But, as housing supply responded to the increase in home prices—housing starts rose from a 1.5 million annual rate in mid-2000 to a 2.3 million annual rate in early 2006—the positive feedback loop began to run in reverse. Home prices began to soften, subprime borrowers found it more difficult to refinance, and mortgage loan defaults and delinquencies rose. As the bust got underway in earnest, residential investment declined and consumer spending was undercut as home equity levels fell.

The housing boom and bust underscores several important lessons. First, the financial sector is not only a very complex system, but also one that can be inherently unstable—subject to excess, then sharp reversal. This is especially the case when an important innovation occurs and market participants don’t fully appreciate the powerful feedback loops that first sustain a boom and then contribute to a bust when the process runs in reverse. This means that we as regulators must continually evaluate the financial system and monitor the landscape for new developments and innovations that, if taken too far, could lead to excess and put the system at risk.

Second, when there are potential excesses that could threaten financial stability, we should look to temper them. For example, in the run-up to the financial crisis, macroprudential tools—such as requiring larger down payments or more closely evaluating the incomes of borrowers—could have been implemented to limit the demand for housing. If such an approach were successful, home prices would not have risen so dramatically, and the subsequent bust would have been less severe. Another approach would have required financial intermediaries to build stronger capital and liquidity buffers as protection against a housing bust and an economic downturn.

Prior to the financial crisis, the conventional wisdom was that asset bubbles could not be identified in real time—rather, they could only be cleaned up after they burst. While there are significant challenges to identifying asset bubbles, it is clear that cleaning up only after they burst does not always work out well in practice.

Third, we need to carefully monitor the incentives that govern the behavior of borrowers, savers, and financial intermediaries.

During the crisis, some examples of bad incentives that sustained the boom included:

1. Compensation practices at financial firms that rewarded volume and short-term performance over longer-term, sustainable returns;

2. The conflict of interest inherent in the willingness of the credit rating agencies to designate tranches of subprime mortgages triple-A in exchange for fees;

3. The ability of Fannie Mae and Freddie Mac to use their implicit government support to take on large amounts of mortgage risk with very little capital backing; and,

4. The ability of AIG to use its triple-A rating to provide credit protection to banks and securities firms against complex mortgage obligations with little direct capital support or an adequate liquidity backstop.

Culmination of the crisis

Once the housing bust got underway, stress on the financial system increased sharply as asset prices fell and bank earnings plunged. In the spring of 2008, such pressures led to a forced sale of Bear Stearns to JPMorgan Chase. Later in the year, the government placed Fannie Mae and Freddie Mac into conservatorship. In September, Lehman Brothers failed. And, a day later, AIG was rescued in order to protect the rest of the financial system against further losses and even broader contagion. With confidence in financial markets and financial intermediaries badly frayed, the Federal Reserve and the U.S. government intervened and provided a range of liquidity backstops, debt guarantees, and capital infusions to forestall a complete collapse of the financial system and the economy.

The bust exposed many structural flaws in the financial system that exacerbated its instability. Without being exhaustive, these included the instability of the tri-party repo system, which supported the nation's short-term funding markets; the risks of runs in the money market mutual fund industry; and the risk of contagion caused by the huge volume of outstanding bilateral (non- centrally cleared) over-the-counter (OTC) derivative obligations between the major financial intermediaries.

The tri-party repo system was centered on two of the major U.S. banks. The system matched investors and borrowers each day—with the investors lending cash, secured by Treasuries and other collateral, to the major securities firms. But, the system was unstable. In times of stress, clearing banks could be faced with very large single-firm exposures—of potentially hundreds of billions of dollars. Not surprisingly, when such counterparties became troubled, the clearing banks were less willing to take on these large intraday exposures. As a result, repo investors, who were primarily worried about getting repaid each morning, were motivated to simply withdraw from the market. As short-term investors withdrew funding, the liquidity buffer of the troubled securities firm was quickly exhausted, particularly as other counterparties to that firm demanded additional collateral to secure their own exposures.

Structural weaknesses in the money market mutual fund industry—which was a major source of short-term wholesale funding to the securities industry and various non-bank financial corporations—also exacerbated the crisis. When Lehman Brothers failed, the value of its outstanding short-term obligations collapsed. The Reserve Primary Fund "broke the buck," and investors rushed to withdraw their funds from prime institutional money market mutual funds in a modern version of a classic "bank run." The funds generally did not have sufficient cash available to meet these runs because they offered overnight liquidity at par value against a portfolio of assets with weighted average maturities that were considerably longer.

Another important source of instability was the large volume of bilateral OTC derivatives positions outstanding among the major firms and the right of a firm to immediately close out such positions if their counterparty became insolvent. For example, when Lehman Brothers failed in September 2008, counterparties to Lehman terminated OTC derivatives in which the contract was in the money (i.e., Lehman owed money to the counterparty) and liquidated the collateral held against those obligations, but kept open obligations in which the exposure went the other way, from them to Lehman. Not only did this create an imbalance in the risk exposures of the failed firm, but it also generated significant market churn and risk as firms scrambled to rebalance their own risk exposures. The contagion generated by the complex web of outstanding bilateral OTC derivative exposures significantly worsened the crisis and was responsible for much of the losses Lehman incurred in its bankruptcy. [2]

The near-collapse of the U.S. financial system underscores three critical lessons.

First, financial institutions must be robust to stress. In particular, they need to have enough capital to be considered solvent even after sustaining significant losses, so that they can maintain the market access needed to recapitalize. They also need sufficient liquidity buffers so that they can respond to shocks without having to sell illiquid assets. The forced sale of illiquid assets can push asset valuations far below their fundamental value, which can increase insolvency risk. And, it is important that they not be overly reliant on short-term wholesale funding, which can evaporate during times of stress.

Second, when we identify potential sources of instability that could amplify shocks, we need to make structural changes to the financial system to reduce or eliminate them. For example, the financial crisis made it clear that changes were needed in how tri-party repo transactions were unwound each day, net asset values were calculated for prime money market mutual funds, and OTC derivative obligations were cleared, settled, and risk-managed.

Third, there should be a viable and predictable resolution regime. We need to be able to resolve a large, systemically important bank or securities firm in a way that limits contagion and stress on the rest of the financial system, while at the same time protecting the taxpayer against loss.

Meanwhile, central counterparties (CCPs)—through which most standardized OTC derivatives must now be cleared—need to be open for business for the financial system to operate effectively. Here, the emphasis should be on ensuring that these financial market utilities can open for business the day after the failure of one or more of their participants. Credible resolution regimes for large banks and securities firms—and credible recovery regimes for CCPs and other critical financial market utilities—should help support confidence during times of stress.

These measures would make the financial system less prone to booms and busts. Financial intermediaries would be more robust to stress when busts inevitably occur, and contagion to the broader system would be reduced when a systemically important firm fails. Such changes should reduce the likelihood of the failure of a large, systemically important firm and the negative consequences of such a failure on the broader financial system. These steps should help to ensure that credit flows can be sustained throughout the business cycle.

Considerable progress

So, where are we relative to what is needed? As I see it, there has been considerable progress. The nation's largest banks are much safer as a result of substantially higher capital and liquidity requirements, as well as robust stress tests. This enhanced resiliency has been achieved without a significant negative impact on the broad availability of credit—recognizing that it is now more difficult for households with low credit scores to obtain a mortgage. Most importantly, improving the capacity of such firms to continue to lend during times of stress should make the overall economy more stable.

We have also made significant progress in addressing many of the structural weaknesses uncovered by the financial crisis. Money market reform has made the prime money market mutual fund industry smaller and safer. The elimination of the net asset value convention for institutional prime money market mutual funds has made these funds smaller and less prone to runs during times of crisis. [3] The tri-party repo system has been made more stable as intraday exposures of the large clearing banks have been dramatically reduced. [4] This means that they have less reason to back away from a firm if it were to become troubled. And, firms are much less reliant on short-term wholesale funding.

We have also reduced the amount of risk in the system by requiring that most standardized OTC derivatives be cleared through CCPs, where multilateral netting occurs. [5] In a centrally cleared regime, major intermediaries have net exposures to individual CCPs that replace much larger bilateral exposures to other financial intermediaries. Of course, this means putting more eggs in the CCP basket. So, it is particularly important now to closely watch that basket. [6] Greater oversight of CCPs is necessary to ensure that they have good governance, sound risk management, robust technological infrastructures, and adequate liquidity support. In addition, we have made considerable progress in developing a viable resolution regime for large, systemically important banks and securities firms.

More work is still needed

Yet, we should not be complacent, as there are important areas where our work is not complete. [7] Relative to other countries, the United States has limited ability to implement effective macroprudential tools. That is because oversight is shared by several different entities, and the power to implement macroprudential tools is constrained. Another challenge is the diverse structure of the U.S. financial system, in which non-banks and capital markets play a substantial role in credit intermediation. Although the Financial Stability Oversight Council (FSOC) could conceivably play a greater role here, whether it will be able to do so effectively remains uncertain.

Another issue that needs attention is the ability to resolve large, complex financial firms that operate on a global basis. The framework of requiring such firms to hold a large buffer of debt that could be converted into equity at the time of non-viability is an important step forward. But, the task of operationalizing this on a global basis in a way that is fully credible to these firms' customers and counterparties has not been completed. Achieving clarity about the roles and responsibilities of home and host country authorities is still a work in progress.

The Federal Reserve's lack of authority to lend to a major securities dealer that gets into difficulty is another outstanding issue. The Dodd-Frank Act narrowed the Federal Reserve's authority under Section 13(3) of the Federal Reserve Act. No longer can the Federal Reserve lend to an individual securities firm or non-bank financial intermediary. Such authority may not be as necessary now that the Federal Deposit Insurance Corporation (FDIC) has the power to lend under Title II of the Dodd-Frank Act and firms are required to have sufficient resources to support their resolution plans. But, I would prefer having such a tool available in extremis given the potential need to buy time for coordination and critical decision-making. I think it is important to ensure that one can "get to the weekend." Finally, the work needed to ensure that CCPs can always recover has not yet been completed. This is an issue of increased importance given that their role in the financial system has become more prominent.

Where the pendulum may have swung too far

At the same time, there are some areas where the pendulum may have swung too far, where the costs of regulation—including compliance costs and the potential impact on the provision of services—are likely to exceed the benefits. In this vein, I favor regulatory relief for smaller banking organizations. First, such firms individually are not systemically important, and therefore do not pose a significant risk to the viability of the U.S. financial system. Second, the regulatory burdens on smaller firms can be heavy because they don't have the scale over which compliance and other regulatory costs can be spread. Regulatory requirements should be appropriately calibrated to avoid inadvertently creating a competitive advantage for larger financial firms.

I also think that the Volcker rule could be modified so that its implementation would be less burdensome. As I see it, regulators could review the criteria for permissible market-making. Trading activity should be viewed as market-making when it is customer-facing and inventories are not excessively large or stale. Market-making serves an important function, and it is important that trading desks can intervene and buy during flash crashes or sell during flash surges. Permitting this could provide greater liquidity and stability to financial markets. I would also exempt smaller banking institutions from the Volcker rule since they rarely, if ever, engage in proprietary trading.

Do no harm

Many speculate that Congress will make changes to the Dodd-Frank Act. If the scope is confined mainly to small bank relief and adjusting how the Volcker rule is applied, I have no objection. But, because the Dodd-Frank Act addresses many of the key lessons of the crisis, I think it appropriate that changes be made carefully—with a paring knife, rather than with a meat cleaver. Here, I would underscore the importance of preserving higher capital and liquidity requirements for systemically important banks; Title VII, which mandates the central clearing of standardized OTC derivatives; and Title VIII, which gives the Federal Reserve an oversight role for financial market utilities that are systemically important, and which helps promote more uniform risk management standards.

While Title II gives the FDIC the authority to resolve a large, complex financial firm by converting its debt into equity and establishing a new holding company, I do not think this is necessarily the only way to have a viable resolution regime. However, if Title II were to be eliminated, then the Bankruptcy Code would need to be bolstered. There are two essential requirements: the ability to initiate an effective resolution strategy over the weekend, and a government entity—be it the Federal Reserve or the FDIC—that can provide a credible liquidity backstop to the recapitalized entity when it opens for business on Monday morning. If resolution cannot be accomplished in this timeframe, confidence would suffer and there would be contagion. Without a credible liquidity backstop, clients and counterparties would run, making it much more difficult for the recapitalized firm to conduct its business.

I would also preserve the authority of the FSOC to designate non-banking firms as systemically important and subject to supervision by the Federal Reserve. As I see it, the designations of GE Capital and AIG were successful in two important respects. First, Federal Reserve supervision resulted in improved corporate governance and risk management. Second, it created incentives for the firms to alter their operations to become less systemically important in order to be de- designated. We should also retain this designation tool because we cannot predict which firms and activities may emerge and become systemically important in the future. After all, I do not think many were focused on or worried about the activities of AIG's Financial Products Group several years before the financial crisis, though in retrospect those activities proved to be systemically important. That part of the firm should have been better supervised and regulated.

Summing up

In conclusion, as we reflect on potential changes to the U.S. regulatory regime, we should not lose sight of the horrific damage caused by the financial crisis, including the worst recession of our lifetimes and millions of people losing their jobs and homes. We had a woefully inadequate regulatory regime in place, and while it is much better now, there is still work to do. We should finish the job as quickly as possible, and we should do no harm as we adjust our regulatory regime to make it more efficient.

Thank you for your kind attention. I would be happy to take a few questions.

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[1] Figures are based on the CoreLogic home price index (including distressed sales) and the PCE price index as the deflator.

[2] For more background, see Fleming and Sarkar, The Failure Resolution of Lehman Brothers, December 2014.

[3] For more background, see Chen, Cipriani, La Spada, Mulder and Shah, Money Market Funds and the New SEC Regulation, March 20, 2017, and Cipriani, La Spada and Mulder, Investors' Appetite for Money-Like Assets: The Money Market Fund Industry after the 2014 Regulatory Reform, June 2017.

[4] For more detail, see Tri-party Repo Infrastructure Reform.

[5] For more background, see Over-the-Counter Derivatives.

[6] To paraphrase Andrew Carnegie and Mark Twain.

[7] For related remarks, see William C. Dudley, Principles for Financial Regulatory Reform, April 7, 2017.

Fonte: Bank For International Settlements (BIS)

https://www.bis.org/review/r171107b.pdf

François Villeroy de Galhau: Are the regulations implemented to guarantee financial stability compatible with the required acceleration in euro area growth?

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Académie des sciences morales et politiques (Academy of Moral and Political Sciences), Paris, 6 November 2017.

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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". [1] 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.

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 [2] 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. [3] 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 [4] 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” [5] – 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. [6] 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. [7] 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 21 st 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 [8] 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. [9] 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. [10] 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. [11] 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 [12] 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. [13]

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. 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. [14] 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. [15] 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.

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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Fonte: Bank For International Settlements (BIS)

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Andreas Dombret: We can work it out – or can we? Current challenges in Brexit talks

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at an event of the Atlantik-Brücke at the Travellers Club, London, 8 November 2017.

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1 Introduction

Ladies and gentlemen,

It's a great pleasure to be with you in London, which for me has always been the embodiment of both British and international spirit.

Just a few miles from this building, 52 years ago, on 20 October 1965, the Beatles recorded their hit "We Can Work It Out" at EMI Studios, later renamed Abbey Road Studios.

This song is about the difficulties in repairing a damaged relationship. The legend goes that Paul McCartney delivered the up-beat mood, concentrating on the possibility to work it out – before John Lennon added the rather sceptical voice. Thus, the attitude of the song swings from positive to negative. To me, this clash of messages describes the current state of the Brexit talks better than anything else.

Currently everyone is asking whether the EU and the UK can work it out. Yet, in a way, it's too late: the train has already left the station. The UK will leave the EU, and that will include a full- blown exit from the single market and the customs union.

But on another level, we can still work it out, as we can still find an agreement that achieves the two big goals: a stable and friendly political alliance as the foundation for close cooperation in foreign and security matters, and economic cooperation that allows for an efficient division of labour and trade.

From an economic point of view, the question then is: can we still work out a deal of close cooperation with little in the way of friction? Or will we break up entirely and trade on quite prohibitive terms?

I remain optimistic that we can achieve a good deal for both sides, and I remain committed to this outcome. But what does that mean?

For me it means two things. First, there is no need to panic: even the worst-case scenario is manageable from an economic viewpoint. Yet, it will have serious effects on our economic process.

Thus, and this is the second point, if we want a strong economic partnership that's based on a sound political partnership going forward, both politicians will need to work out the best possible terms for economic cooperation; and businesses have to prepare meticulously.

Today I will talk about the current challenges on the road ahead. I will begin by outlining the consequences of Brexit and explain why a disorderly Brexit may mean substantial losses for the UK. The disorderly exit, as I will go on to show, is unfortunately not that improbable given the difficult current state of negotiations. That's why firms and politicians must prepare for a disorderly exit, too. I will focus on the financial sector to highlight what that means. Nevertheless, I will close with an optimistic outlook on the terms of our future cooperation

2 What if we don't work it out?

But, first let's take a look at what's at stake. What are the economic consequences if we don't work it out?

Well, economic impact analysis is anything but an exact science, but we can sketch some likely scenarios. Seeing the writing on the wall, the UK government has apparently begun to realise that a hard – that is, a disorderly – Brexit without a new agreement would have serious repercussions for the UK economy.

This impact will come via two main channels. The first is the trade and investment channel. Exporters will lose out as a result of the restricted access to the single market, and supply chains may suffer substantially.

The second channel is the migration channel. The UK's access to highly skilled workers from abroad could take a severe hit. I recognize that migration has played a big role in the Brexit vote – but, especially today a failure to attract highly-skilled workers via migration could have a detrimental impact on future UK growth.

The economic impact on Europe will be limited by comparison. Take Germany for instance. The UK is an important export market, accounting for 7% of German exports. But that's only 2% of value added to the German GDP. Therefore, Brexit will most likely not result in a major setback for the German economy. Bundesbank simulations confirm that even a hard, disorderly Brexit would be manageable from Germany's viewpoint.

To sum up: the costs of Brexit will most likely be much higher for the UK than for the remaining EU, though a disorderly exit would, without doubt, substantially disrupt economic cooperation on both sides – just think of the transnational supply chains.

And these consequences were not transparent to those who voted to leave the EU. In contrast, many voters held the EU responsible for wage stagnation, job loss, precarious job conditions or a lack of rural development. In the end, they protested by voting to leave the EU.

The frustrating thing is that the UK's exit from the EU will not help to overcome these issues. In fact, economic disintegration may even worsen the situation. That's why national policies on both the European continent and in the UK as well as EU-27 policies must take those who have lost out through economic change seriously and find tangible – not emotional – solutions.

3 Can we still work it out?

This will be a challenge that runs in parallel to the Brexit negotiations, and it is likely to be a long- term challenge. At the moment, it also looks as if the Brexit negotiations are going to be a drawn- out, very long-term process – progress so far has been quite disappointing.

In June this year, the EU and the UK agreed to settle the divorce arrangements first, before entering into talks about the future relationship. These issues are the divorce bill in respect of the UK's outstanding liabilities, the future status of EU citizens living in the UK and vice versa, and the border between the Republic of Ireland and Northern Ireland. Yet, to this day progress on the three issues has been thin on the ground – they are far from being settled.

The only logical consequence following the EU summit three weeks ago was to conclude that progress was insufficient to embark on the second phase of negotiations. The EU-27 leaders were united in their assessment that talks about the future relationship – that is a free-trade agreement and a transition period – could not yet be started.

In addition, however, they chose a far-sighted communications strategy. They made clear that the questions surrounding the divorce – while showing disappointing progress – were actually quite solvable and that talks about the future relationship could be initiated as soon as December, at the next EU summit. This is far-sighted because it strengthens Prime Minister May's quite difficult position at home, where she has to tread a fine line between the extreme camps of the "leave-now-without-any-deal" Brexiteers and the "remain-as-close-as-economically-possible" supporters.

But we have to be careful, as there may be a hint of method in the UK's political turmoil. As we know from international negotiation theory, a leader can use domestic dispute as a negotiation resource, arguing that she cannot move any further because she has no room for manoeuvre at home. That's why it was necessary for EU leaders to call for the UK to deliver soon in order to move on to phase two in December.

In sum, then, the state of negotiations has to be taken seriously – but there is no reason to panic. Why not?, you may ask, as the outlook seems quite dramatic.

There are two reasons. First, the process we are witnessing is not that unusual for complex political negotiations – they take time, and in the beginning both sides typically weigh up their options and their opponents first. Thus, it is often the case in such negotiations that concrete results only become visible shortly before the deadline.

That it takes time is also quite sensible, seeing as a lot is at stake. The decisions taken will influence UK-EU relations for decades; moreover, they will have a lasting impact on global supply chains and geopolitical constellations.

The second reason why we need to keep calm is that the UK government is apparently ready to compromise. While Prime Minister May's speech in January was widely perceived as indicating a hard Brexit – (quote) "No deal is better than a bad deal" (unquote) – her tone and stance have softened in the meantime. This was clearly signalled in her Florence speech.

We now know that the UK government aims to strike an ambitious free-trade deal and reach a customs agreement. In exchange, they are prepared to offer permanent residence for EU citizens and a clear budgetary commitment regarding their liabilities.

Overall, therefore, the chances of reaching a deal might be better than they appear at the moment.

4 Hope for the best, but prepare for the worst

Given this calm assessment of mine, some may conclude that firms could simply sit back and wait. Nothing could be farther from the truth. Let me explain why, by focusing on the financial services sector. What will the impact of Brexit be on financial institutions?

Financial institutions should prepare for the worst case – that is, a "no deal" scenario – with a disorderly exit of the UK in March 2019.

As daunting as it seems, this "no deal" scenario is – if we take a positive view – luckily, quite clear; there will be no surprises. WTO rules will apply, as the UK will be a third country. With regard to banking, the relevant EU regulations and directives will necessitate a licence from an EU supervisor.

Therefore, banks are well able to prepare for this scenario and so make the worst case manageable. The necessary preparations certainly mean costs and a heavy administrative burden for banks, and they are complex and time-consuming.

Yet, despite these costs, it would be irresponsible to speculate on one particular outcome of the talks – such as a possible transition period – and adopt a wait-and-see strategy based on that educated guess.

Let me be crystal-clear. Preparations should already be well underway; if not, they must start now! Banks must establish at least basic entities in the EU – and, vice versa, in the UK – before it's too late. In many cases, that means applying for new licences and a great deal of paperwork.

While I am concerned about the state of preparations at some banks, I am at least as worried about the current position at other firms. For them, the pressure to prepare for the worst – and to do so now – may be even greater.

As I said, the “no-deal” scenario represents an event with clear terms – with no hidden surprises – but, of course, there will be no surprises only if a company thinks this scenario through and asks itself: how would it affect us, our customer relations, our product offerings, our supply chains, and in terms of regulatory approval, and so on?

Think of it as a Brexit stress test. If – and only if – you prepare meticulously, you won’t be caught out by the “no deal” scenario. So, the motto must be: Hope for the best, but prepare for the worst. The potential repercussions of inaction are huge. Firms have to act now!

5 Friends after the break-up? Terms of future cooperation

Supervisors are playing their part to support preparations. We are taking a strict, yet at the same time pragmatic approach. What do I mean by that?

Our aim is to make the transition as smooth as possible. We are providing a clear point of contact for banks, explaining our supervisory approach and offering guidance with the licensing.

Here is one example: when EU supervisors examine a bank’s internal model used to calculate regulatory capital requirements, they could proceed – for the time being – from the findings of the Prudential Regulatory Authority. Similarly, the PRA could build on the verdict of the EU’s Single Supervisory Mechanism. For that to be viable, both the PRA and the ECB or the Bundesbank would need detailed information on each other’s decisions. Close, responsible cooperation would have to be in place between supervisors.

But no bank should put its money on supervisors’ mercy. We take our mandate seriously – there will be no blank cheques. We will not accept shell corporations – we will license only if banks build risk-appropriate risk management functions in the EU.

That’s why it would be so important to work towards a meaningful free-trade agreement that integrates services in a pragmatic manner. There could be an agreement that safeguards a high regulatory standard without imposing undue processes. But first, negotiations would have to move to the second phase.

6 Conclusion

Ladies and gentlemen, I am optimistic that we still can achieve an orderly Brexit, with a solid future relationship between the EU and the UK.

However, the current negotiations must gain in speed – if the British government can find a constructive approach that unites the country and enables progress on the divorce issues, we might see substantial acceleration.

But even then, it remains a highly challenging undertaking to reach an agreement in a timely manner. And let us not forget that a disorderly exit will remain an option until the very end.

Fonte: Bank For International Settlements (BIS)

https://www.bis.org/review/r171109b.pdf