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Strategic and regulatory challenges with emerging financial trends

JACQUES DE LAROSIÈRE:

Ladies and gentlemen, I am delighted to moderate this panel with such eminent speakers. We have Andrea Enria who is the Chair of the European Banking Authority. We have Steven Maijor who is the Chairman of ESMA, the European Securities and Market Authority. We have Douglas Flint who is the Chairman of the Group of HSBC and we have Jérôme Brunel, who is the Secretary General of Crédit Agricole.

The idea is to ask you to discuss the consequences of the change in the economic and regulatory context that you have to face, which is characterised by low interest rates, probably lasting low interest rates, regulatory strengthening, which is not over and still in part to come, hopefully, the increasing role of market financing, digitalisation, developing FinTech instruments, new players, litigation risks. I mean there are a lot of issues that are on our road. I would love to ask you to discuss some of these challenges. I will give the floor to Douglas Flint to start off.

DOUGLAS FLINT:

Jacques, thanks very much. It is always a pleasure to join you in these occasions. We are in unprecedented times. Economics, geopolitics, structural reform, financial inclusion, recovery and resolution, new entrants, data dependency, technology regulation, financial crime, responsibilities and enforcement penalties are making those of us in the regulated sectors have particularly interesting lives. Thank you for those who give us that fascinating life!

There is no question in my view, after seven/eight years of regulatory reform that the industry is far stronger and resilient than ever before.

But have we got the balance right between constraining, which was necessary because of the financial crisis and enabling? Do we have a vision of where we are trying to get to

because if we don't know whether we are going to get there, to quote the great Yogi Berra, "If you don't know where you're going you might not get there."

Have we got the right incentives for making the allocations that we seek? It is perverse but I always think that in every public policy discussion, emphasis is placed on infrastructure and small business lending but yet they are the most penalised assets within the regulatory environment and the most advantaged are residential mortgages and government debt. In other words, we obsess about getting more money into SME lending but the regulatory framework creates incentives to fund government debt and housing finance. We got what we incented.

Another example: One of the big differences between North America and here is where we place mortgages. Is it right that the straightforward European mortgages should be within the banking system or should there be a gradual drift to a securitisation model or should there be a policy choice made to promote this? A drift to the securitisation model would create more capacity within banks to undertake the role they are uniquely qualified to perform which is giving credit to smaller enterprises. Now is there sufficient clarity and stability in the regulatory framework to allow a long term view?

The asset classes that people would wish us to finance require public policy decisions that go well beyond three to five year horizons if we are talking about energy policy, infrastructure and so on. Within the regulatory system it is very difficult to make allocations into asset classes when you don't know whether the risk weightings are going to change in the near term or in the long term, certainly over the life of the asset.

We talk a lot about liquidity but what about having a policy debate about where we want liquidity risk to reside? It will exist. Do we want it in the private sector, the public sector, in the long term insurance funds, asset managers? Do we want it on bank balance sheets? Let us the public decision makers make a decision on where we want it and then think about whether we have got it in the right place.

There is a big debate to have whether the balance between technocratic and regulatory impact and political choice is the appropriate one. A huge amount of responsibility has been delegated to regulators and technocrats. They are now making decisions that go well beyond, in my view, financial stability but towards the shape and size of economies, which politicians might believe that they have some accountability for to those who elected them to be engaged in. So we should think about whether we have got that right.

Allied to that, we should have a far reaching debate about how do we want to use the public balance sheets? It seems to me that the public balance sheets should be engaged only where they do things that the private sector is not prepared to do and that gets you back to some of the asset classes that we think are important, like infrastructure, in particular the early stages of infrastructure projects. Do we want to use government balance sheets, government contingent risk on things that the private sector can't do, or do we want to continue to use the public balance sheets to support cheaper government debt and trying to incent more first time buyers into the residential housing market?

If we focus on the impact of technology, not just the benefits of more competition, financial inclusion, better compliance, our industry is going to be at the pinnacle of a great deal of discussion around the balance between the benefits and privacy use of data, data security and the disruptive risk of an enormous amount of data being held by central clients.

Then finally, three points:

One, have we created the right framework that will attract the people we want to the industry? I'm not going to speak for more than a nanosecond on the dreadful subject of remuneration except to say that in an environment where people get more and more concerned about financial crime and cyber risk, our ability as an industry, which is one of the most sensitive to those risks, finds it very difficult to recruit people skilled in financial crime and cyber in technology because, certainly from a UK perspective, when you tell them they will get paid in seven years' time, that's not a particularly compelling alternative to being paid in cash at the end of the year by a non-European, non-British employer.

Are we comfortable that the pre-distribution of losses that is now emerging will allow us to have a soft landing? I think we kill ourselves when we say that we are too big to fail by pre-distributing the losses that will arise. Surely we want to avoid the losses, not simply have a pre-distribution into the savings and pensions sector, which effectively hits the same people as tax payers. In fact it hits a far wider body of citizens than the tax payer imposition would do.

Then the final issue, do we need to have a grownup discussion about why, seven years after the crisis, the cost of capital of banks has not come down. If banks are so much safer than they were pre-crisis, why has the cost of capital not come down? Part of that is uncertainty about the future of regulation and the future of the economies but have we done enough to think about how we promote the environment where recovery is the more likely mechanism for unexpected losses to be recovered because the system is capable of being refinanced by private money because it is adequately profitable to attract that money, or do we want to continue to have a system where, in many parts of the world, particularly in continental Europe, the banks don't make the cost of capital and then recovery will never be an option, it will be straight to resolution. Thank you.

JACQUES DE LAROSIÈRE:

I think you have said it all in your inimitable way. I think you have said it all but we still need to elaborate a little bit on that. Stay with us. I will ask Jérôme Brunel from his perspective of managing a very large institution that is focused on lending to corporates, to mid caps to individuals. I would like him to tell us a little bit how he feels about all this seven year regulation and other problems. Jérôme, go ahead.

JÉRÔME BRUNEL:

Thank you, Mr. Chairman. I don't know if I have really something to add to what you have said, everything was there. I will stick also to the regulatory strengthening which is a non-stop one. That is the problem. It is paradoxical. This non-stop regulatory strengthening is becoming a risk although its objective is to mitigate the risks. Indeed it represents a serious risk regarding our ability to finance the economy, which is "our raison d'être". I am referring not only to our lending capacity but also the availability of bringing liquidity to the markets. We wonder if we will still be able to provide our European customers with liquidity. It could be a major issue for Europe, only having non-European providers of liquidity to European customers. That is, for us, a major issue.

Furthermore, we are really supporting the increase of market financing but it will take time before market financing offsets the lending activity of banks. We are supporting this move. We would like notably to support the initiative of the European Commission on securitisation. But as it is drafted at this stage, the proposal of the Commission would be a failure. No additional investor would come into this already depressed market of securitisation. Even the definition of the Standard Sample and Transparent (SST) securitisation is not including really the basic one, i.e. the ABCP.

On a more positive stance, we are incurring various risks that you referred to at the beginning of the session but these risks could be turned into opportunities. For instance, higher compliance standards are, for banks, opportunities to reaffirm their role as preferred trusted partners because they are offering to our customers the highest level of technical security.

I would like to stress that we are concerned by another fact: we are not concerned by the opening of competition, a newcomer coming in, not at all. We are concerned by the fact that these newcomers are not playing on the same level playing field. It is damaging for competition but it is damaging for the customers themselves because they are not assured that they could deal with newcomers protected by high technical standards. So yes, we are in favour of this competition but on the same level playing field. In sum, while increased competition is welcome, "Fin tech" companies and new players must be held to the same licensing, security and liability rules as financial institutions to ensure fair competition but importantly also to ensure high levels of consumer protection and reduction of risks.

JACQUES DE LAROSIÈRE:

Thank you very much. Now that the prosecution has spoken, I will ask firstly Andrea Enria to answer. I allow myself, because I am an old man and because to some extent you are a professional son of mine, I will ask you not to dig your heels into the bunker but to really try and take into account what you have heard over the last quarter of an hour, which is not ill intended. I know these two gentlemen. They are absolutely frank and of extreme goodwill. So I would like you to address these issues.

ANDREA ENRIA:

Well, I have never had the sensation of being in the position of the powerful bureaucrat. The first point is about regulators listening to and engaging with the industry and other stakeholders. I do really believe that we are listening. We do devote a lot of time and efforts to public consultations and I can quote many changes we made to the rules following comments received from the industry.

Now, moving to the claim on overregulation, have we done too much? Has regulation come to the point of jeopardising the lending capabilities of EU banks and driving to a significant adverse effect on the economy? I find this difficult to believe. I do not deny that there could be areas in which we overshot and where we need to review the rules after carefully assessing their impact. I welcome the fact that the Commission has already announced a review of the prudential framework. We intend to contribute seriously to it, maintaining an open-minded attitude.

We have already proven that we stand ready to review the regulatory framework and make new proposals when we think the requirements got too far. The EBA work on simple standard and transparent (SST) securitisation is an example of this attitude. We conducted an in depth review of the current regulatory framework and proposed changes, with less stringent requirements for simple products with good quality underlying assets. I listened to many criticisms to our work during this conference and find many of them unfair – for instance, on ABCP we adjusted the proposals to reflect the input received from the industry during the consultation. You should not forget that on the issue of securitisation we are still pushing as European regulators at the global tables to have our proposals approved and we are facing significant resistance from other regulators, for instance from our friends in the United States where the securitisation market has significantly recovered notwithstanding the harsh regulatory framework introduced after the crisis by the Basel Committee is fully implemented.

It is clear that we do have a lot of pressure on profitability of banks. This is coming from the regulatory tightening, the lasting low interest rate environment and from competition. The return on equity is still significantly below the cost of equity.

Now how do you address this and what can regulation do? If we look at the relationship between capital requirements and lending, there is a tendency to oversimplify the issue. A number of empirical studies show that banks which have beefed up the capital faster are lending more. It is the reluctance to adjust to the new requirements, coupled with the postponement of drastic measures to address asset quality problems that seem at the core of the sluggish lending activity of banks, especially in some regions.

The issue of the speed of the adjustment process is key. In the US authorities injected rapidly public money to recapitalise banks, pushing them to recognise losses, raise additional capital in the markets and pay back the government. The timing of the capital

strengthening has been much more compressed there than in the EU. And this has supported a faster recovery in lending.

In the EU the debate is often focused on SME lending, which has particularly suffered in recent years. But we also have to acknowledge the relevance of the asset quality deterioration for SMEs loans. SME non-performing loans represent in Europe on average 18% of total SME loans, and the percentage rises to 21 if you consider also restructured loans.

We have introduced a supporting factor which alleviated the capital requirements for SME lending and we have been judged as non-Basel compliant also because of this measure. We are now making an analysis related to this supporting factor and have to report to the Parliament, the Council and the Commission. I don't have the final results of our investigation but still preliminary results show that the supporting factor is not having a major effect on lending. There is no differential effect between lending to SMEs and lending to large corporates, while asset quality is a much more important factor in explaining lending behaviour to SMEs. There are studies also from the IMF showing that if you have a ratio of non-performing loans which is above a threshold around 6%, then loan growth becomes close to zero or moves into negative territory. So in my view one of the big challenges in front of us now is fostering the restructuring of SMEs' debt. Alleviating the burden of debt for SMEs parties is essential for re-creating the conditions for growth and job generation in this sector of our economy.

I keep hearing complaints that regulators keep tightening the requirements, but I am really committed to close the reform package agreed by G20 Leaders seven years ago. These reforms, in my view, design a rather comprehensive and reasonable adjustment to capital and liquidity positions.

As to market liquidity, I repeat that we need to better understand what is happening in the markets. Is it all due to regulation? Of course, there are other factors at play as well: for instance, keeping inventories – and therefore fulfilling market making functions - is costly for banks also because of the very low interest rates environment. But there could be an impact of regulation, we don't deny that. We need to understand which specific aspects of the regulatory framework are generating such impact and what can be done to avoid unintended consequences. That is where the dialogue with the industry is most important. We are open to this discussion

JACQUES DE LAROSIÈRE:

Thank you very much, Andrea. I think you lived up to a certain degree to my expectations because you are a very intelligent person, if I may say so. I think you are extremely well intended, which does not mean that all that you propose is necessarily correct but you made a valid effort.

Now I'll turn to Steve who has been less under attack. Steve Maljoor is the Head of ESMA and he has been doing a very important job over the last years. I would like him to add his own input to the discussion.

STEVE MAIJOOR:

Thank you, Jacques, for giving me the floor. Let me react to a couple of points that were made.

Firstly, regarding the fact that it is now time to evaluate the rules and regulations in response to the financial crisis, it is important to realise that we are still in the middle of the implementation of the regulatory reforms and many questions that were raised by Douglas Flint will unfold in the coming years. It will still take a number of years before we really see the outcome of the joint effects of the different pieces of legislation in response to the financial crisis. Obviously, that is not a reason not to already evaluate existing pieces of legislation. For example, recently we have looked at the effects of EMIR on derivatives markets, how is it affecting the functioning of the derivatives market, what we can already learn at this stage. Again, I would like to emphasise that it will take more time to really get to a full picture of the implementation effects of the whole regulatory reform.

Secondly, regarding the impact of the regulatory reform on economic growth, we should realise is that, while the regulatory reforms have been done with stability and investor protection in mind, alongside we have really progressed with the single market and providing better opportunities for businesses to do business across the EU. If you are looking, for example, at the post trading area, this was very much a national affair until a few years ago. Now, with the introduction of both EMIR and CSDR, there is really the opportunity to turn that into a European market where market players can compete on a level playing field. I am very supportive of the Capital Market Union but we should realise that the regulatory reforms in response to the crisis already had very important impacts in terms of integrating European capital markets and providing better opportunities to do business across the EU. The trading area in the previous decade, with trading venues becoming more competitive, illustrates this integration process. Similar developments will now happen in the post trading area. Actually it is already happening with CCPs and CSDs. So also the single market has been progressing in response to the financial crisis.

Thirdly, there are still a lot of operational issues that need to be solved around data issues. I share some of the mixed views on data collection around the new pieces of legislation. Many new pieces of legislation have data collection requirements both for national regulators, and for European regulators. We are indeed improving our data capabilities at a European level. It increases our risks as we now have many data in our house and it means that if something goes wrong, you might have been able to detect it and stakeholders will consider that you are responsible. On the other hand, looking back to the risk discussions that we had until four or five years ago, we were working with data reports and risk analyses of banks without our own data and assessments. We needed to improve this situation. There are still a lot of operational issues that need to be solved around data issues. At the same time, you cannot supervise in the dark, we need to have a better understanding of the developments in the capital markets if we want to effectively identify risks and respond to them.

I would like to echo the words of Andrea Enria. Clearly liquidity has changed structurally in financial markets. It has been made more expensive to be involved in market making but obviously also the monetary policies of central banks across the world are affecting liquidity. It is too early to jump to conclusions and to say there needs to be another policy response to liquidity issues. So let us first assess the issue. If you are looking at the facts of the matter, the evidence is quite mixed. Also the fact that we have ultra-low yields is an indication that apparently investors are not asking for a compensation for liquidity risks. Let me make a final comment on the liquidity issue. We should also realise that you can have a lot of market making in good times but the question is will it still be available when the going gets tough. If we go back to 2008, when we needed it, it was not available. So, market making in good times is not necessarily available in more difficult times.

JACQUES DE LAROSIÈRE:

Thank you very much, Steve. I took your points. The only point on which I am somewhat uneasy in what you said is that as we are only halfway in the implementation part of the regulation, it would take another five years before we could really make a synthetic view of all this. This I do not agree with. I think it is like in medicine, you can't really reason in that way. If the medication is not working or if it is producing very bad effects, you cannot wait for the finalisation of the initial programme before you make judgements. Now I think it is not because the regulation is still "en cours" that you can't make a judgement on it and make adaptations. That's what I wanted to say. That's where I have a difficulty. Answer please.

STEVE MAIJOOR:

Very briefly, the main reason for making that point was not to be defensive and to postpone these evaluations but I think in the presentation of the issue there was the feeling we have this now behind us and let us now look at where we are. It was a kind of indication. There are still important impacts of the regulatory reform we need to look at and they will develop in the coming years. Indeed, it should not be any reason for complacency.

As I have just said, we are already evaluating some of the changes that we have made. At the same time, there is the element also of predictability and to what extent can market participants prepare for upcoming changes if while they are coming they are changed again. It is not to be complacent in the evaluation but it is also to look at the costs and benefits of making those changes on the way up.

JACQUES DE LAROSIÈRE:

Okay. We only have five minutes left. I will ask perhaps the two bankers to just not re-state their points which have been very clearly made initially but to add whatever thought they might have in a few minutes. So perhaps I will start with Jérôme Brunel.

JÉRÔME BRUNEL:

Thank you. I would like to change the subject and speak about the digitalisation of financial services. Banks have been surfing on the wave of digitalisation for already quite a long time. What is new is probably the pace and the scale but banks usually or generally are quite close to offering their customers fully-fledged direct banking. That shows by the way that banks, even the big banks, are much more flexible and adaptable than one can think because they have been successful in that direction.

Even though now, we will not go for all direct banking services to our customers but we will be, like probably many others, a multichannel one, because those are the needs and the expectations from the customer.

The challenge for banks is to provide the financial advisor with the global picture of a relationship with the customer because the customer can utilise several channels before having a face to face meeting with his advisor. This is a major challenge. The other one is probably the use of data because we are in favour in Crédit Agricole of being extremely protective of the intimacy and confidentiality of figures, even though we know that utilising all data could service the customer in the best way. But I think we must be extremely cautious about that.

JACQUES DE LAROSIERE:

Thank you, Jérôme. Doug would like to speak.

DOUG FLINT:

Thank you. I will make three quick points. The notion of quality of assets was mentioned and of course that is terribly important but in a banking system which has been massively expanded in capital, we ought to be reflective about whether this is the time to allow the system to take more risk in the sense that I think it is far more risky to continue to lend to inflate the price of real assets and comfort oneself with the illusion that because property prices are going through the roof and we are lending less and less as a proportion; that is less risky than financing real activity.

Secondly, it is real activity and new assets that grow economies, not refinancing old assets

because that adds nothing to the economy, it just inflates asset prices. So what we ought to be doing is finding a way to create new assets. If the problem is that there is insufficient equity in small and medium sized businesses to allow them to expand through debt then let us try and solve that problem by finding a way to get more equity into smaller businesses so that they are financeable.

Then the final point is about allocation of resources. One of the phrases we use is the rule of 52. There are only 52 weekends in the year and, curiously in a 24/7 world, it is only at the weekend you can make system changes. For the next two years, all of our weekends are to do with regulatory change and financial crime issues. It is got nothing to do with new tech, nothing to do with new technology and the expansion of business proposition. We are allocating the vast majority of the technology and operational resources for the next couple of years to the past. If there is another five years to go I would only have one more rule which is no more rules.

CONCLUDING REMARKS: JACQUES DE LAROSIÈRE

Thank you, Doug. I am not going to sum this up. But I will just give one thought. You have two aspects in regulation, two sides. One side is to strengthen financial institutions basically by obliging them to put more own funds on the table. That has been done masterfully by you all. I cannot deny that. You have played a historic role in increasing the capital base, the equity base of the banking system in Europe. I want this to be well established.

Then you have another aspect in regulation and it is a more complex and sometimes debated aspect. It is the regulation that is supposed to provide incentives for the actors in the system, to channel resources into some, perhaps preferred by public opinion, by the governments, investments. Now we have to be very careful on this because the world of which I am speaking is littered with terrible examples of wrong incentives, white elephants and things like that.

But in the present juncture there are two specific cases where you have to make a judgement on the right balance between prudence, regulation on the one side and the incentivisation part of it on the other side: Infrastructure investments and securitisation.

On infrastructure investment, this is interesting because it is newer investment. It is not just carrying old investments through financial instruments that are going to be sold. It is new stuff. I am told by the profession of private investors, insurance companies that the present balance in the Solvency II upcoming regulation is not going to entice anyone to buy such assets. In that case, the Juncker plan fails because you don't have the attraction of the private part.

Now, it may be that those who like this regulation are totally convinced that it would be extremely imprudent to tilt the balance a little more towards providing appetite for the private sector. I can make no judgement on this but I say if we feel that at this point of sluggishness of the European economy, it is worthwhile taking a limited risk because, after all, investment opportunities are usually very resilient in terms of their capacity to earn and

to resist. If you could make a little move towards what the private industry is asking, I don't think you would be hurting the architecture of what has been done. I think you would just be giving a chance to that opportunity. If it doesn't work, if it's too much and you have a too buoyant an infrastructure market with prices that go high, then of course you rein in. But I don't think that in the present situation of Europe you'd have such an exuberant situation.

The other one is closer to EBA and that is securitisation. You have made a significant effort on the senior tranche which has been, in terms of capital charges, well calibrated but there is now a gap between the senior tranches and the junior tranches which is not, in my view - and I'm not a deep specialist of the question - which is not substantiated by a rigorous analysis of the increasing risks in terms of the repayability of the instruments of these assets.

Therefore, what I would like is for the Commission, because I think this is more in the hands of the Commission than in EBA, for the Commission to relook at this question because you cannot have a good calibration for senior tranches and a totally disincentivising system for the other tranches because life doesn't work like that. You have a continuum from the senior tranche to the lower tranches. You have to take into account the respective asset quality, as you rightly said, of these different tranches. This is not yet in the regulation and I make a modest plea, which is to try and move into something that is not totally disincentivising securitisation because securitisation, as I said with Gary Lynch a moment ago, is not taking off in Europe at all, contrary to what is happening in the US. There is a regulatory obstacle here which I think has been detected and which is not something enormous to repair. That is where I think it is good for the tailor to look at the way the suit that he has made fits on the client.

We had a comic after the War when we didn't have many new suits because of the restrictions and one guy had the money and the idea of having a new suit so he went to the tailor and he got a new suit. Now when he came to the tailor for the first test, premier essayage, it was awful. The tailor said to him, no, it is not awful, your shoulders are not put in the right position. So put your left shoulder here. So the guy did this. Then he said yes, okay, that's a little better but you need to move your back in this position. It was absolutely irresistible in terms of laughter. Eventually the guy complied with the tailor's recommendations. He was of course so crippled and ridiculous that the whole thing made the audience laugh. Don't put yourself in the position of the tailor. Put yourself a little bit in the position of the client and if he tells you that something really doesn't work, at least look at it. Okay, well thank you very much for the session and all the best.