Christian Noyer: It was vital to break the adverse feedback loop between bank and sovereign risk

Interview with Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, in *Les Échos*, 17 September 2012.

* * *

Do the ECB's announcement to purchase sovereign debt and the German Constitutional Court's approval of the European Stability Mechanism mark a turning point in the crisis?

These announcements were welcomed by the markets and the outlook now appears much clearer. The European Stability Mechanism is a key factor for strengthening the cohesion of the euro area and demonstrates that the euro is here to stay and irreversible. It will help ailing economies return to competitiveness and growth. The Governing Council's decision to purchase, subject to appropriate conditions, government debt is reassuring for at least three reasons: purchases are potentially unlimited, which should end speculation about the possible collapse of the euro area; the strict conditionality will oblige countries to pursue their fiscal consolidation efforts; lastly, these purchases fall squarely within the ECB's mandate as they are conducted in the secondary market and aim to ensure the proper transmission of the policy stance to the real economy.

The ECB has played its role. What must governments now do?

Euro area Member States need to restore their credibility and they are already making efforts to do so. Some have had to implement austerity plans and others, less drastically, are undertaking structural reforms and continuing to reduce their government deficits. This is the case of France. Even if these efforts appear moderate compared to those of other countries, they are necessary for our market credibility.

Brussels has presented its proposals for a European bank supervisory mechanism; are they in line with your expectations?

Yes, they are. The developments of the financial crisis have brought to light one of the euro area's fragilities: the link between bank and sovereign risk. Following the collapse of Lehman Brothers, governments bailed out their banking systems and, in doing so, established a nexus between sovereign debt and local banking systems, which interferes with monetary policy transmission. When the euro area sovereign debt crisis erupted, bank refinancing conditions became correlated with sovereign risk, with the consequences that we have witnessed for ailing countries. The large amount of liquidity provided by the Eurosystem has reduced this impact, but funding costs have remained very high in some countries. It was therefore essential to decouple sovereign risk from bank risk. The banking union will ensure a sounder monetary union.

Germany has expressed doubts as to the proposed set-up, in particular with respect to the number of banks covered by the ECB. Could this prove a threat going forward?

The proposed union implies a transfer of sovereignty from States to the ECB, which Germany has always wished for. As regards the scope of supervision by the ECB, there were no doubts that all banks had to be covered. The problems often stem from small- or medium-sized banks, as we saw in Ireland and Spain. To ensure credibly vis-à-vis the markets, across-the-board coverage is necessary.

In practice, how will the tasks be divided between national supervisors and the ECB?

The legal responsibility for supervision would be transferred to the ECB, but in concrete terms, national supervisors would continue to supervise banks on a day-to-day basis. In fact, it is a mechanism similar that of the Eurosystem: under the authority of the Governing Council, the supervision committee, bringing together the ECB and the heads of national supervisory authorities, will coordinate supervisory actions and the allocation of tasks with the national supervisors. In practice, the ECB would be responsible for major decisions regarding prudential supervision: assessing capital adequacy in relation to risk, compliance with regulations, etc. I would also like the ECB to have decision-making powers in dealing with cases of distressed banks.

Questions remain as to division of powers between the ECB and the European Banking Authority (EBA)

The distribution of tasks seems clear to me: the EBA is the European body responsible for banking supervision. It sets prudential rules and standards and ensures that they are applied; the ECB will be the euro area bank supervisor. The EBA's governance arrangements will have to be changed slightly, as the Commission proposes, to take account of the banking union. The UK has nothing to fear from the creation of a single euro area supervisor.

What would have changed if the European supervision system had have been in place, for example for the Crédit immobilier de France (CIF)?

Technically, not a lot. Instead of the French *Autorité de contrôle prudentiel*, the ECB would have asked the CIF to increase its capital. But make no mistake, banking supervision is not a catch-all insurance. In the case of the CIF, we were aware of its fragility stemming from its increasing refinancing difficulties and we knew that there were longer-term liquidity risks. The CIF is a textbook case where a downgrade by ratings agency expedited the disclosure of funding problems.

Would you say that Moody's was responsible for this situation?

No, the primary responsibility lies with its management, which was unable to find a merger solution when it was possible and we had asked it to do so.

Did you lack coercive power in this case?

Yes, definitely. We have very great powers when an institution does not comply with regulations, but we do not have powers that enable us to prevent a crisis. As things stand, we can appoint temporary administrators if need be or revoke an authorisation, but we do not have powers of resolution allowing us to impose the restructuring of a banking group or transfers of assets. We worked on a draft regulation before the European project started to be discussed, but we underestimated the length of time needed to arrive at a European proposal. I regret this somewhat as it would have been useful for us.

Is the French banking system still sufficiently robust?

In fact, French banks are increasingly robust as they are reducing their risks and increasing their capital. The reduction of risk has resulted from the selling-off of business lines, often abroad, and a scaling-back of some market activities; the increase in their capital reflects the setting aside of profits that remain substantial thanks, in particular, to the resilience of retail banking in the face of the economic slowdown. Their core tier 1 capital grew by 0.5 percentage point in the second quarter and they have exceeded the target set by the EBA. In terms of liquidity, they have managed very well the withdrawal of US money market funds last year by adjusting their assets, as well as the rebalancing of their sovereign bond portfolios. This goes to show that, if it is based on a sound internal model, the universal banking model works well.

Do you remain opposed to the separation of investment and retail activities?

I really do not understand the benefit of this principle of separating activities. The only thing I wish to see is the outright prohibition of speculative activities and stronger internal controls for the risks associated with market activities. Otherwise, banks should be able to serve their customers, whether they are private individuals, companies or institutions, in all of their operations – on bond markets, forex and hedging operations, and creating savings products. For all of these reasons, I do not fully understand the concept of separation, whereas I do understand that of stopping speculation.

At the same time as bank failures are continuing, banks have obtained an easing of their liquidity constraints under Basel III. Isn't this a paradox?

That's not what it's about. We have always believed that a liquidity ratio was necessary – and, incidentally, we have applied our national rules for many years, which is not the case everywhere. But the draft agreement was finalised too quickly and we had to rework it. We need to strike the right balance between strict regulation and supporting the financing of the economy.

But will the timetable be put back?

Yes, I am in favour of putting it back a bit, if necessary, in order to make these major trade-offs and to give banks more time for the implementation phase so that they can adapt to the new standards.

Should banks carry less sovereign debt?

Banks should facilitate the financing of the economy; from this point of view, they should not hold huge quantities of sovereign bonds, even if these constitute liquid assets that are precious in assets and liabilities management. But the excessive concentration of liquid assets on sovereign debt in the calculation of the liquidity ratio can run into difficulties – either when the sovereign has its rating substantially downgraded or, on the contrary, when the country has low levels of debt, such as Australia or Switzerland.

Will the long-term liquidity constraint, the NSFR, eventually be abandoned?

We will work on it again as of next year.

Should the Solvency II standards for insurers also be delayed?

We have a particular problem concerning long-term business lines (i.e. life insurance, civil liability, construction). Designed before the crisis, this system of standards, which adjusts portfolio assets according to their market value, is not suited to a highly volatile environment like the one we have seen for the past five years. We need therefore to ask again the fundamental question: are the basic assumptions underlying Solvency II correct? And we need to seek to reduce volatility by getting closer to economic reality. Here again, we should not set rules too quickly the impact of which may be very great but has not been fully assessed in times of crisis. I think that it would be fruitful to try out several different technical solutions over a number of years before laying down the final rules. In any event, I recommend that French insurers continue with their preparations in order to be ready technically in 2014 as if the standards were going to enter into force as scheduled.

Is the programme of job cuts that you have just announced for the Banque de France sufficient when compared with staff levels at other central banks?

I find the accusations about the supposedly excessive staff levels at the Banque de France exasperating. They are based on spurious international comparisons since other central banks – such as the Bank of England – do not print their own banknotes, do not (yet) incorporate the banking supervisor and do not perform tasks such as the management of over indebtedness, which is entrusted to the Banque de France by law. More than 200,000 households debt applications processed every year is no mean feat! We have already made a great effort over the past few years as our staff levels have been cut by nearly 20% in ten years. And we will continue with this effect; but it is based on a detailed analysis of our activities and requires substantial investment in order to increase productivity. Our programme is ambitious but in keeping with the reality of the tasks we perform and respectful of our employees.