Presentation of the 2018 *Financial Stability Review*

Paris, 25 April 2018

Speech by François Villeroy de Galhau,

Governor of the Banque de France

Between "shadow" banking and an angelic vision of the market:

towards a balanced development of non-bank finance

Press contact: Mark Deen (mark.deen@banque-france.fr).

Ladies and Gentlemen,

I am very pleased to welcome you this morning to this presentation of the 2018 *Financial Stability Review* (RSF), dedicated to non-bank finance. Intended as a forum for dialogue and exchange, the FSR offers leading personalities from diverse backgrounds the chance to have an open debate. I am delighted to see many of this year's contributors here among us this morning, and I would like to extend my warm thanks to all the speakers: Klaas Knot, President of the Dutch Central Bank; Philip Lane, Governor of the Central Bank of Ireland; Robert Ophèle, President of the *Autorité des marches financiers*; Paul Hamill, Global Head of FICC at Citadel Securities; Yves Perrier, CEO of Amundi; and Richard Portes, Professor of Economics at the London Business School.

The topic we have chosen to address is far from anodyne: [slide 2] according to the Financial Stability Board (FSB), non-bank financing totalled USD 160 trillion in 2016[i] [Monitoring Universe of Non-Bank Financial Intermediation, MUNFI], up 50% relative to 2008 and accounting for close to half of all financial assets held by financial institutions worldwide, compared with 40% in 2008. And yet – or maybe precisely because of this – there is still much heated debate over its scope and over what exactly it should be called. In order to better understand it, we need to rid ourselves of two mindsets: first, one of irrational fear, as non-bank finance also enables the financing of growth and innovation; and, in contrast, an over-idealised or "angelic" vision of the sector, as shadow banking does indeed carry risks and regulators have a role to play in mitigating them.

**

1. Overcoming our irrational fears: the benefits of market-based financing

To overcome our irrational fears of non-bank finance, the words we use to describe it matter. Is it "shadow banking", with all the negative connotations this implies, or rather, as some regard it, "market-based finance" or "non-bank credit intermediation"? For the title of this FSR, we have chosen the term "non-bank finance" in its broadest sense. The work carried out by the FSB enables us to better determine its scope: the higher measure, which is entity-based [Other Financial Intermediaries or OFIs], puts the total at USD 99 trillion. However, those activities liable to pose a risk to financial stability, that is "narrow shadow banking", only account for USD 45 trillion, in other words a little under 30% of total non-bank finance.

Market-based finance is still not very widespread in the euro area: [slide 3] it accounts for just 20% of total non-financial corporation debt, with the remaining 80% taking the form of bank lending. In the United States, these proportions are reversed. We should stress here that, of the larger euro area countries, France has the highest proportion of market-based financing, at 40%. Non-bank financing in France totals EUR 1.748 trillion, and the leading asset

manager in Europe is a French firm, Amundi. France also has an internationally recognised regulator, in the form of the AMF, while Paris is home to the European Securities and Markets Authority, ESMA. After Brexit, I also have every reason to believe that a significant share of the market activities of the largest global banks will be based in Paris.

First of all, I want to put an end to the non-debate over whether market-based finance is better than bank-based finance and vice versa, and the misconception that the US system should be replicated in Europe: working towards a balanced development of non-bank finance simply means giving companies the option of diversifying their debt financing. Fundamentally, the real debate lies elsewhere: it is about switching from debt to equity. This is crucial in advanced economies, where growth is dependent on innovation. Equity financing is better suited to the uncertainty and often long-term returns associated with innovative projects. The euro area is seriously lagging behind in this respect: equity only accounts for 74% of GDP,[ii] compared with 125% in the United States. Moreover, it only makes up half of the total external financing of euro area corporations (equity + debt), compared with three quarters in the United States.

In practice, how can we successfully diversify the sources of financing? At the national level, I am pleased to see that the “Pacte” law drafted by the Minister for the Economy and Finance seeks to foster long-term and equity-based life insurance contracts – by overhauling Eurocroissance – and encourage and simplify retirement savings, including the annuity component which has the longest investment horizon. Moreover, one approach supported by the Banque de France is the implementation of an ambitious European framework: [slide 4] a "Financing Union for Investment and Innovation" to better channel the euro area's EUR 400 billion savings surplus into equity financing and innovation.[iii] This Financing Union needs to unite and build on existing initiatives, first and foremost the Capital Markets Union, but also the Banking Union and the Juncker Investment Plan. It also means making concrete progress in several areas: the revision of accounting rules, taxation and insolvency laws in order to facilitate cross-border investment, notably in equity; the European-wide development of long-term savings products and investment vehicles such as venture capital funds; the completion of the Banking Union.

2. Avoiding an angelic vision: monitoring, testing, regulating

So no irrational fears in the face of the shadows; but no angelic vision either. [slide 5] A portion of shadow banking is still overly exposed to credit, liquidity, leverage and maturity risk, and there is significant potential for these to spread to the rest of the financial system and cause financial instability. We discussed this issue at the IMF and G20 meetings in Washington just last week.

In my view, therefore, there are **three priorities** for regulators [slide 6]: monitoring, testing and regulating. **Monitoring** first, thanks to the compilation of detailed data on shadow banking. The FSB already contributes to this with its annual report on shadow banking, as does the ESRB with its *European Union shadow banking monitor*. But we need to go further: we need an even more precise picture of the sector as participants and business models can vary considerably from one country to another, and are sometimes extremely complex. It is particularly crucial to put together a mapping of the interconnections within the shadow banking sector and with traditional banks and insurers.

The second priority is to be able to **test** for systemic risks, using appropriate tools. In order to measure the global impact of shocks, we have a particular need for liquidity macro stress-tests that take into account investment funds: the latter are especially vulnerable to runs, in the event of a stock market crash for example, if they are open-ended and have no system of gates. To achieve this, we need to develop, jointly and at a global level, a harmonised framework for systemic stress tests: the FSB already recommended such tools in 2017, but there is a real risk that they will remain in the exploratory phase, and that no action will be taken at the level of the financial system.

The third and last priority is to **regulate**. Following the finalisation of the Basel III reform in December 2017, the main focus for financial regulation is no longer bank solvency, but non-bank liquidity. We nonetheless need to avoid making two mistakes. The first would be to favour one sector over another, be it banks or shadow banking: the existence of opportunities for regulatory arbitrage could to lead to the transfer of capital-intensive activities to less regulated, or even unregulated entities, which would be counterproductive. The other mistake would be to impose banking regulation on shadow banking, as the risks are not the same; in particular, the same capital requirements cannot be applied.

At the global level, the non-bank sector needs to be provided with microprudential and macroprudential regulations that are tailored to its particular business model and risks. With regard to macroprudential regulation, France is a pioneer in this field with its decision to introduce, as of 1 July this year, a measure regarding large enterprises that also takes into

account their market debt. We shall publish details on how it will work this week. But we need to be honest with ourselves and admit that our experience of using macroprudential tools outside the bank sector is still very limited. One of our priorities in terms of regulation should also be to develop liquidity management tools for investment funds, and to refine the measurement of their leverage, two issues that, fortunately, the FSB has already identified. It is also important that we increase the transparency of shadow banking activities. In this respect, the entry into force of the European regulations EMIR2 and SFTR should be a considerable step forward.

As I've been talking about macroprudential measures regarding large corporations, and our subject is financial stability, I'd like to bring you up to date on bank lending in France: lending to the private sector – to households and businesses – is growing rapidly in France, at a rate of close to 6% per year. At the next meeting of the High Council for Financial Stability (HCSF) in June, we shall look at whether we need to introduce additional measures.

**

To sum up, we have not yet finished exploring the issue of non-bank finance and I am certain that today's event will make a valuable contribution to the debate. I would like to pass the floor now to Aurélia End, who will host the round table, and wish you all an excellent morning.

---

[i] Data as at end-2016 covering 29 jurisdictions which together account for 80% of global GDP. See FSB, March 2018, *Global Shadow Banking Monitoring Report 2017*.

[ii] In the fourth quarter of 2017

[iii] 12-month current account surplus for the period ending in January 2018. Source: ECB.