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Xavier Musca & David Wright

Speakers

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David Wright

Ladies and gentlemen, I have the great pleasure and honour to have next to me Xavier Musca, who I have worked with and to whom I was rather secondary in his chairmanship of the Economic and Finance Committee in Europe. Everybody knows about his extraordinary career. Of course, before he went to Crédit Agricole, he was the Secretary General of the Président de la République. I am leaving out of a lot of his past. Xavier is now with Crédit Agricole.

Xavier, at the beginning of the year we saw some extraordinary movements in the capital markets. We saw the valuation of bank stocks decline very rapidly and an enormous amount of volatility; and I have never really heard a very clear reason as to why that has happened. Maybe you can help us here.

Xavier Musca

Thank you very much, David, for your kind words. Good morning to everyone. I am very pleased to have the honour to speak to you today.

The point you made is a very relevant one because I think, for the first time since 2011, we have clearly seen the banking sector stock coming under heavy pressure from the markets while we are not under the strain of any sovereign crisis and while monetary policy is very much directed towards ensuring supposedly great stability within the Eurozone. So the real question is: why has that happened?

The persisting divergence between the cost of capital for EU banks and the profitability

The key reason for that has to be found in the persisting divergence between the cost of capital for European banks and the profitability, which is a distinctive factor which persists through time within the crisis despite the fact that interest rates were lowered very significantly and are now negative for monetary policy. Indeed, the cost of capital remained at the level of 10% while profitability for the European banking sector as a whole remains quite low, at around 5% approximately. That may be a difference with our American friends, even though the latest results from the American banks have not shown great resilience to the current environment.

The key question, therefore, to ask ourselves is why there is this persistent discrepancy; and I think we can briefly highlight a variety of factors. Some of them are well known and I will not expand on them. They are the key risks which affect the global financial system, strategic risks, problems in emerging markets, oil and so forth. That is common throughout the banking sector in Europe and elsewhere.

The second key issue is that the banking sector, specifically but not only within Europe, is also challenged by the need of digitisation. I am not worried about that much in the long-term. The banks in Europe have adapted themselves. They have a key distinctive factor which is that they have the confidence of their customers. I think that will persist but obviously digitisation means new entrants, not all of whom have submitted to the same rules as in the normal banking system. That is a problem, specifically in Europe, and that has created pressure on the margins. On top of that, it implies a huge amount of investment if you want to keep on the edge. A bank like mine will invest €7.7 billion during the next four years, out of which €5 billion is devoted to digital. It is a huge amount of money which, at the end of the day, will affect our profitability even though there are also opportunities associated with that.

The third key factor which explains the elevated cost of capital in Europe is that, despite all the efforts undertaken, some buckets of risks that are associated with certain banks and certain countries continue to persist. I will not elaborate too much on that but I really think that all the initiatives which are undertaken in order to deal with NPLs in certain countries are very relevant in this respect because they will allow for reducing the perceptions of risks by investors.

I also have to say that, in my view, part of this discrepancy between the cost of capital and profitability in Europe is also triggered by the uncertainty surrounding regulations and, to be totally frank with you, I do not think that the way we manage this sort of issue in Europe is particularly illustrative of our common capacity to face challenges in a co-ordinated way. I have been struck by the fact that, on a very specific issue that we were confronted with at the end of last year on the question of MDA, there were three different answers brought by three different regulation entities in interpreting exactly the same EU regulation: the ECB way, the Danish way and the British way. It is difficult to understand why there were three different interpretations with quite large differences among the three through the application of exactly the same EU Directive. That is a real challenge.

I am sorry for the long answer.

David Wright

Not at all. Looking at the regulatory issues here, you were saying that the implementation and interpretation of existing rules is variable. Jean Lemierre was saying the same. But there are still developments of the rulebook in Basel. Do you think that is too much? What are the issues that worry you here? Is it TLAC? Is it leverage ratios? Is it risk-weighted assets? Is it all of them? Which is the most important?

Xavier Musca

Well, I would say two things. The first difficult issue is really about predictability and homogeneity. I understand that, for example, on MREL there could be differences in the way that the same rules are applied throughout the different jurisdictions. It is therefore very difficult, when you are confronted with analysts and investors, to explain the rules which will apply to you. That there remains such uncertainties on the regulation and the way they will be applied is in itself an issue because investors, legitimately so, will ask you 'What will be the consequence of all the regulation on you?'

I also think MREL and TLAC are each interesting ideas and I will not comment on the potential advantages or disadvantages of either of them. The real issue is the consistency between these two rules and to what entities they will be applied. Are we going to have a two-tier regime in which some banks will be submitted to TLAC because of G SIFIs and others not? With the others being submitted to MREL, we would be completely sure that there would a change of buckets but nevertheless no disruption in competition rules. That is really uncertain and I think that one of the key issues in the next months will be precisely to try to clarify and to unify as much as possible of this regime so as to deliver a clear and consistent picture within the Eurozone as well as for the whole of Europe.

The Basel 4 requirements could lead to a significant increase of capital requirements for EU banks

On your last question, which is very much related to the so-called Basel 4 agenda, I would say that I am a bit puzzled over a few remarks. Firstly, we hear our supervisors and regulators regularly repeating that they do not want significant increases in the capital requirement deriving from the application of the new rules which are contemplated in Basel these days. At the same time, we understand that, for some of them at least, an increase of 20% in capital requirement and RWA is not significant. We do not have exactly the same judgment obviously and it has not had any predictability.

The last element is that when you look at what could be the impact of this regulation in specific areas on the basis of the documents published today, you could reach levels which are very impressive as far as we are concerned. As you know, we have a very strong position in specialised financing like aircraft, shipping, railways and motorways. The impact in RWA terms of this regulation will be a multiplication by four. So what is the message behind that? That we should close these activities? Are they profitable to the EU economy? Is it that we have to further raise the level of capital gain? Our supervisors are telling us that that is not the purpose but what could the final outcome be? I am very struck by the fact that this could also have, as I said, a macro economic impact. I remember that in 2008 we made huge efforts in order to preserve international trade through these new Basel rules while we see, for example, that trade finance could be penalised and RWAs associated with them could be doubled in certain scenarios.

It is therefore difficult to understand what the beneficial impact could be on the real economy or on the financial system. My plea would be that the most urgent task for Europe should be to try to resume growth and to harmonise the legislation within Europe rather than to have new models of a banking system which has been weakened, as is reflected by your initial question, and whose profitability is at stake, creating some anxiety from the part of investors.

David Wright

Xavier, let us conclude with one other question. We heard from Jérôme yesterday about this infrastructure specialised financing point and he was arguing that, actually, the risks and the non performing loans in this sector are very low, so it is quite surprising that the capital levels should need to be increased in the way you are suggesting. But my question really is: do you think that the specificity of Europe is sufficiently recognised within Basel? Could Europe try to co ordinate more inside the Basel community to put forward more common views in these discussions? It seems to me that that is an important point.

Xavier Musca

I fully agree. I think that a lot of progress has been made. Even recently, as I understand, the ECB was not in full capacity as a member of the Basel Committee. They were not considered. They were not considered to be voting members since they were not, before the banking union, considered to be supervisors. So I think that a lot of things have to be improved in the co ordination of the EU.

I would also say that, in my view, Europeans have to adopt a change of philosophy. It is fine enough that the Basel Committee sets the rules but are we obliged to implement them irrespective of our priorities in terms of growth and so forth? I very much respect our American friends but, as far as I understand, not all of the banking system in the US, to say the least, has submitted to Basel. On the other hand, all of our banks have submitted to Basel. So the impact of this regulation has to be measured against the fact that all of us will have to apply these rules and that the potential impact on growth is not exactly the same in the different regions, without even talking about the key factors around the predominance of bank financing in Europe, which is a distinctive factor which makes us quite different from our American friends.

Either we wait more in Basel or we manage not to apply immediately and strictly all the dimensions of this regulation, which – and this is another philosophical debate – are not really going in the right direction since we have learnt over the years that we were responsible for risk and we have to manage it very closely. The message which is now going through all these floors and discussions, etc. is, in my view, going in the opposite direction because it does not create an incentive for you to properly manage and properly measure the risk that you are taking.

David Wright

I think that is a very interesting message on which to close. Thank you very much, Xavier. I think that what you have said about having a degree of flexibility here, given the imperative of finding the growth model again in Europe, is important. If we cannot find a growth model, we are in desperate trouble here. I think that has to underlie all of our immediate short-term priorities. I fully agree with what you said and thank you so much for being with us this morning.

Xavier Musca

Thank you, David.

Acronyms Used:

- ECB - European Central Bank
- NPL - non-performing loan
- MDA - maximum distributable amount
- MREL - minimum requirement for own funds and eligible liabilities
- RWA - risk-weighted asset
- TLAC - total loss-absorbing capacity