DEUTSCHE BUNDESBANK
EUROSYSTEM

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Back home: making the G20 Summit commitments work

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Contents

1 Introduction 2
2 Dealing with SIFIs 3
3 Illuminating the shadow banking system 6
4 Implementing Basel III 9
5 Conclusion 10

1 Introduction

Ladies and gentlemen,

The recent G20 Summit in Cannes was another decisive step towards a more resilient international financial system. The work to develop a new regulatory framework is slowly but surely nearing completion.

Nevertheless, we still have a long way to go to make the commitments work back home. Ultimately, it is the globally consistent implementation and transposition of the agreed policy measures into national laws and regulations that will count. In terms of effectiveness and consistency of these internationally agreed reforms and standards, it is therefore a great plus for the international community that the FSB is strengthening its implementation monitoring.

I would like to focus on three key areas where consistent implementation is most critical:

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(1) addressing the risks posed by systemically important financial institutions (SIFIs for short),
(2) strengthening oversight and regulation of the shadow banking system and
(3) putting into effect the new capital and liquidity standards for banks, known as Basel III.

I would now like to briefly discuss these areas in more detail.

2 Dealing with SIFIs

The past few months have witnessed substantial progress in tackling the SIFI problem. In Cannes, the G20 endorsed the comprehensive policy framework presented to them by the Financial Stability Board (FSB). The requirement for SIFIs to hold additional capital above the Basel III minimum standards – which was specified by the Basel Committee on Banking Supervision – lies at the heart of this concept. To this end, an initial set of 29 global systemically important banks has been identified. To take account of dynamics within the financial system, the set will be updated annually with respect to its number as well as its composition.

SIFIs will have to meet the additional loss absorbency requirements with common tier 1 capital, which is a particularly good buffer for covering losses. The specific amount will be determined on the basis of each SIFI's systemic importance, currently ranging from 1.0% to 2.5% of risk-weighted assets.

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I very much appreciate the FSB's recommendations, as such capital add-ons are an appropriate measure for improving the resilience of SIFIs, forcing their owners to take greater responsibility for their actions. Moreover, they put a price tag on the implicit government guarantee that SIFIs enjoy, thereby reducing misguided incentives to take excessive risks and countering competitive distortions.

Nevertheless, it was clear from the outset that strengthening SIFIs' loss absorbing capacity would not be enough. We should remember and be very clear that failures are part and parcel of a market economy. Unfortunately, the crisis has revealed a significant lack of suitable instruments for effectively dealing with failing financial institutions. These gaps in legal frameworks must be addressed. SIFIs, too, must be able to exit the market in an orderly manner that does not expose taxpayers to the risk of loss.

A number of jurisdictions have already adopted legislation to improve their resolution regimes. For instance, the German Restructuring Act, which came into effect at the beginning of this year, includes a significant extension of supervisory powers, allowing authorities to restructure and resolve banks. Yet, despite the progress made at national level, obstacles to the effective resolution of financial institutions remain. National resolution regimes are clearly stretched to their limits when it comes to globally operating SIFIs. One of our main tasks in the coming months will therefore be to ensure mutual compatibility between different national resolution regimes.

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In this regard, the *FSB Key Attributes of Effective Resolution Regimes for Financial Institutions*, which were also endorsed by the G20 in Cannes, represent a major leap forward.[1] The Key Attributes constitute a new international standard and serve as a point of reference for the overhaul of national resolution regimes, setting out elements needed for enabling the orderly resolution of financial institutions, irrespective of their size or importance.

The Key Attributes require jurisdictions to have a designated resolution authority in place that possesses all necessary powers to intervene in and resolve financial institutions that are no longer viable. This includes specific legal powers as well as the operational capacity to implement orderly resolutions. In addition, for internationally active firms, institution-specific cross-border cooperation agreements should and will be established. The Key Attributes also call for the establishment of Recovery and Resolution Plans (RRPs) for global SIFIs, supported by resolvability assessments to evaluate the feasibility of resolution strategies. The objective of these plans is to organise the recovery or resolution *ex ante* in such a way that systemically important units or functions can be maintained without systemic disruptions.

Following their endorsement by the G20, the Key Attributes now have to be put into effect across jurisdictions. This will require substantial efforts by both national authorities and financial institutions. Legislative changes will be needed in many jurisdictions to ensure that national authorities can exert all necessary powers. Recovery and resolution plans must be developed and,

[1] See Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011.

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finally, financial institutions may need to change their structure and operations to ensure their resolvability.

Looking ahead, the FSB framework will be extended from global to other SIFIs. In Cannes, the G20 called on the FSB to deliver, by April 2012, possible ways to broaden the framework to include banks that are systemically important at national rather than international level. Furthermore, there are concrete plans to include, in the medium term, other financial market players such as insurers, financial market infrastructures and non-bank financial institutions.

3 Illuminating the shadow banking system

The next challenge I would like to address is the need to look beyond the banking system and to illuminate what is known as the shadow banking system. We should bear in mind that the shadow banking system is not a new, autonomous part of the financial system. Most entities and activities ascribed to it are already subject to some kind of monitoring and regulation.

Yet the crisis has made it painfully clear that the shadow banking system can become a source of systemic risks and endanger the entire financial system. To reduce these risks, gaps and loopholes in the existing regulatory framework need to be closed. Undoubtedly, we have to act fast, as the stricter rules imposed on banks via Basel III and the rules for SIFIs clearly pose the risk of activities being shifted to less regulated areas. We must not allow risky behaviour previously taken on by banks to be pushed into the dark.

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Much work has already been done in this respect. In Cannes, the G20 endorsed a comprehensive set of recommendations put forward by the FSB. These recommendations call for both an effective monitoring of the shadow banking system and, where necessary, regulatory measures.[2] To improve monitoring, the FSB has set out high-level principles for the relevant authorities and a stylised monitoring process. The FSB will conduct annual monitoring exercises to assess global trends and risks in the future. The results of these global assessments will be reported to the G20.

Getting back again to national authorities: their main task is now to implement the FSB's recommendations for effective monitoring in a timely and internationally consistent manner. In order to gain a comprehensive picture of the shadow banking system and the risks it poses, authorities must put in place an appropriate system-wide oversight framework. Ensuring that national authorities have sufficient powers to collect all necessary data at an adequate frequency is of utmost importance in this context.

Yet improving data availability will require substantial efforts. For instance, in order to obtain a picture of the shadow banking system's scale, national authorities must be able to draw on high quality, consistent data on financial sectors' assets and liabilities – this is known as Flow of Funds data. Unfortunately, in many countries a number of limitations in the Flow of Funds statistics have come to light. Aggregating or comparing these data across jurisdictions has proven to be especially difficult.

[2] See Financial Stability Board, Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board, October 2011.

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Furthermore, *better monitoring* of the shadow banking system will not be enough; *better regulation* will be needed too. This could be achieved either by regulating banks' interactions with the shadow banking system or by regulating activities and participants in the shadow banking system themselves.

The FSB has already initiated work to assess the potential case for regulatory actions. It has set out general principles for designing and implementing regulatory measures in order to strengthen international consistency and to reduce opportunities for regulatory arbitrage. Over the coming months, the FSB, together with competent standard setting bodies, will issue a series of studies and recommendations for regulatory actions which will deal with identified gaps and with inconsistencies in national regulatory approaches. These recommendations will then, once again, have to be implemented at regional and national level, calling for further substantial changes in laws and regulations.

We should keep in mind that, when designing new monitoring and regulatory measures, our actions must be forward-looking and we must be mindful of unintended consequences. Given the fluid, evolutionary nature of the shadow banking system, we should not focus solely on risks which have come to light during the current crisis. We have to be sufficiently flexible to capture future developments as well. In this respect, exchanging information across jurisdictions on a regular basis is crucial.

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4 Implementing Basel III

I would like to finish with a few words about the new capital and liquidity standards for the banking sector, commonly known as Basel III. The new rules represent one of the key pillars of financial sector reform as they will significantly strengthen banks' resilience by raising quality, quantity and international consistency of bank capital and introducing global liquidity standards. Last year, at their Summit in Seoul, the G20 committed themselves to implementing the new framework.

Unfortunately, over the last months, some market participants have raised fears that Basel III might hamper economic recovery or would damage national interests. Yet this is not the case. The new rules are indispensable for improving banks' resilience and will generate substantial benefits by reducing the likelihood of financial crises as well the output losses associated with such crises in the future.

I therefore warmly welcome the fact that, in Cannes, the G20 leaders took the opportunity to call on jurisdictions to meet their commitments to fully and consistently implement the new Basel framework within the agreed timeframe. Individual countries should not seek to gain advantages by watering down or reluctantly implementing internationally agreed reforms.

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5 Conclusion

Ladies and gentlemen,

To sum up:

The cornerstones for making the financial system more resilient are now in place. Nevertheless, much remains to be done. We must put our commitments into practice and translate the agreed reforms into national laws and regulations. In particular, we need

- to ensure that *all* financial institutions can be resolved without destabilising the financial system,
- to better illuminate the shadow banking system and put in place regulatory measures where necessary and
- to implement the new Basel framework consistently across jurisdictions.

Thank you for your attention.

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