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Fundamental issues of stabilising the financial system

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Ladies and gentlemen

What I was afraid of has occurred. There is hardly anything more difficult than speaking after Michael Heise. Actually, he has already said all there is to say. But since I cannot simply stay silent, I would like to discuss with you some fundamental issues of stabilising the financial system. And I hope that my thoughts will perhaps have some small value added, even though I quite deliberately do not wish to go into the very recent events. My topic will therefore not be crisis management but the long-term prevention of crises. I would certainly be missing the point of the topic I am dealing with if I were now to list the whole wealth of existing proposals on stabilising the financial system. There isn't enough time for that anyway. Therefore, instead of going into details, I shall try to highlight the fundamental issues that underlie many of the recommendations for action.

I have chosen to take this approach not least because I am also constantly concerned with fundamental issues precisely as a result of my work and involvement in the Financial Stability Forum. For example, one of the questions that arises for me this morning is how the institutional structure for maintaining the stability of the financial system should be configured in the long term, especially in the United States. Or, even more basically: how much freedom should the market participants have in the financial system and in what areas are the degrees of freedom to be limited?

These questions are the reason why, for my talk, I finally chose a matrix with keyword headings which feature all those recommendations for action that we encounter almost every day in the media. These headings include "enhancing transparency", "refining Basel II", "reforming deposit guarantee schemes", "regulating rating agencies", and "modifying monetary policymakers' operational framework". Under these headings, such recommendations relate to three sets of fundamental and interconnected stability issues, namely

1. key issues in the area of regulation
2. questions about the institutional structure for financial stability, and
3. fundamental issues with regard to procyclicality.

To put it quite plainly, in setting the individual topics against the fundamental issues, it has again become very clear to me that a lasting stabilisation of the financial system calls for a holistic, system-oriented policy approach, which is based on institution-oriented banking supervision but which also goes beyond it.

Let me start with the fundamental issues in the area of regulation.

I Fundamental issues in the area of regulation

Put in a nutshell, fundamental issues in the area of regulation relate to the tension between the poles of self-regulation and sovereign regulation. In other words, where are market solutions possible and where is sovereign regulation necessary? Another question is about the political level at which this fundamental decision is to be taken. Is it the national, the European or the international level? This adds a further, complex dimension to the underlying tensions and strains between self-regulation and sovereign regulation. I shall return to this point in a moment.

But allow me first to emphasise that, in a market-based system, approaches involving self-regulation are the obvious course to take. Put in simple terms, the state in this case relies mainly on the fact that the market participants, first, set the standards themselves; second, that they will commit themselves to complying with these standards and, third, that they will organise an effective means of monitoring this compliance. Now, given the backdrop of current events, I probably do not need to over-emphasise the fact that, with regard to the necessary stability of the financial system, we cannot trust self-regulation alone. Sovereign regulation that "orders" the financial system is also part of the market economy.

I take the view that sovereign regulation is particularly appropriate where the market players are unable or unwilling to set effective rules or where there are overriding reasons why the regulatory power of government has to be brought to bear. Banking supervision is a prime example of this: not only do banks have a key position in the financial system and, therefore, in the economy as a whole. They also have access, albeit a conditional one, to central bank money. As a result, there is unanimous agreement that self-regulation is not an option.

A fundamental decision in favour of sovereign regulation in banking supervisions by no means settles the question of whether such regulation necessarily has to set detailed and prescriptive rules. Indeed, regulation can also be organised in a principle-oriented way. In this case, the state demands that the market players follow certain principles in their transactions and monitors compliance with these principles. This approach should therefore not be confused with simple *laissez faire*. Rather, it places high demands on all those involved. Above all, principle-based regulation is predicated on the supervisors and the supervised having a shared understanding of the prudential aims.

If, with these principles, I now look closely at Basel II – the regulatory framework which has applied to our banks since January – I find both: rules, on the one hand, and principle-based provisions with room for manoeuvre, on the other. For example, Pillar 1 of Basel II contains clear provisions on how much capital has to be maintained for what credit risks. And, from the Bundesbank's perspective, I would add that these regulations should be partially refined given the experience of the financial market turbulence. Among other things, we are in favour of higher capital cover for re-securitisations. This includes CDOs on asset-backed securities, for example. In addition, we advocate higher capital requirements for credit risks in the trading book and some adjustments in the area of qualified liquidity facilities in the standardised approach for securitisation.

Pillar 2 of Basel II contains qualitative requirements for risk management in financial institutions, which are specified for Germany in the principle-based Minimum Requirements for Risk Management. The disclosure obligations in Pillar 3 also fall into the category of principle-oriented regulation. They leave the credit institutions scope in determining the type and scale of the information they provide.

In my view, all of this shows that, although the question of “rules or principles?” is a fundamental decision of sovereign regulation, it is not necessarily an “either-or” decision. Perhaps that also explains why, in reality, we regularly encounter a combination of principles offering fixed rules and flexibility. I believe that, on the whole, this is likely to be the best way to serve the requirements of a stable financial system as we now understand it. Nevertheless, I can see an approaching debate in which the flexibility of the second pillar of Basel II is at least partially called into question by supplementary provisions. I would warn against this.

As you are aware, however, fundamental issues of regulation for stabilising the financial system arise not only in banking supervision but also, say, in securitisation business, the hedge funds and, as an especially pressing issue, in the case of the rating agencies.

In the United States, rating agencies have to be registered with the SEC. Furthermore, it should be borne in mind that Basel II relies on ratings for classifying bank loans. In Europe there is therefore a procedure with which agencies are authorised for the use of their ratings in determining a bank’s minimum capital.

Following the experience with ratings in the recent financial crisis, the current practice of having only a non-binding IOSCO code of conduct is generally perceived to be in need of reform. The rating agencies themselves are in the process of reviewing their internal procedures and rating methods.

In addition, in May the Committee of European Securities Regulators (CESR) proposed the establishment of an international Standard Setting and Monitoring Body (SSMB) at IOSCO, in which the agencies are to set up standards together with the regulators. Compliance with these standards should then be monitored by the SSMB, albeit without the involvement of the agencies. This approach is claimed to be virtually a midway solution between self-regulation and sovereign regulation.

As you are aware, the European Commission has now put forward a proposal for consultation which envisages an authorisation procedure and the supervision of rating agencies – in other words, sovereign regulation. I would like to make three fundamental comments on this.

First of all, every effort should be undertaken to ensure that solutions at the European level are consistent with a level playing field internationally. The crucial point on which everything hinges should be the IOSCO code of conduct since anything else might result in competitive disadvantages in Europe.

Second, emphasis should be placed on the investors' own responsibility when using ratings. EU registration must not lead to "rubber-stamped in Brussels" being interpreted as a seal of quality for individual ratings.

Third, an EU registration procedure would have to be decentralised in structure; in particular, no new authority should be created. The Basel II authorisation procedure is a good reference point in this respect.

In making this comment, I have now basically arrived at the fundamental question of the suitable sovereign level for regulation. National and international regulations are in competition, with a third way existing in Europe in the form of regulation at the EU level. The more decentralised regulation is, the better it can be adapted to the characteristics of the financial system in question. The more centralised regulation is, the more the same regulatory conditions prevail.

Deposit guarantee schemes are a good example of how the tensions between national and cross-border regulation can be resolved. In Europe we have a minimum level of harmonisation in the form of the Deposit Guarantee Schemes Directive. In Germany, besides this statutory deposit protection at the minimum European level, there exist additional, private protection schemes operated by the various categories of banks.

Not least in the wake of the bank run on Northern Rock last summer, the European Commission is considering a revision of the Deposit Protection Directive. It is aiming for a greater degree of harmonisation. In particular, this concerns a higher level of minimum protection and the abolition of the co-insurance. As the discussion in the EU now stands, this would mean that the principle of subsidiarity would be basically retained. We at the Bundesbank attach great importance to this. Deposit protection has to be consistent with the specific features of the national banking systems.

II Fundamental institutional questions

With the distribution of powers among the sovereign regulatory levels, I am now very close to the second set of fundamental issues. I would now like to talk about a number of fundamental institutional questions about the stabilisation of the financial system. I am doing this because, during the financial crisis, it has become clearer to me than ever before how much institutions matter. I am therefore concerned with the institutional framework for the monetary, supervisory and regulatory infrastructure.

In the USA, the shortcomings of governance in the financial system have been revealed for all to see in the crisis, at the same time posing two major challenges. The first challenge arises from the fragmented structure of financial supervision. In some cases, however, quite new institutional arrangements – that is, institutions – have to be put in place.

With its “Blueprint”, the US Ministry of Finance has now presented an ambitious but cogent overall strategy for a longer-term reform of financial supervision. It envisages a radically overhauled institutional structure with a complete change of design in its tasks. I see one particularly important aspect of this blueprint in that fact that the Fed in the role of a “market stability regulator” would, for the first time, institutionalise a primarily macro-oriented perspective on the financial system. I await with keen interest how this debate will proceed.

With regard to the second institutional challenge in the USA, namely the review of the monetary policy instruments, a lot has already happened. To begin with, the

Fed was not so well equipped with instruments for the liquidity policy action necessitated by the subprime crisis. The Fed was very quick to create efficiently functioning instruments in the crisis, however.

When I now look at the institutional structure for financial stability in Germany and in the Eurosystem, I would like to highlight the synergy effects between operational money market management and banking supervision. The financial market turbulence has shown us quite clearly that these synergy effects can indeed be very large. As the Bundesbank is closely integrated into banking supervision, we can also fully exploit such synergy effects. Our deliberations on the time profile of liquidity provision and, hence, our stance in the Eurosystem benefit from general information from banking supervision. Conversely, the insights gained in contact with the banking industry in the practical conduct of refinancing operations and in payments are helpful to the banking supervisors.

These synergy effects quite certainly played a part in the Eurosystem being able to take early, resolute and successful countermeasures when the distribution of liquidity among the banks was no longer functioning as normal. In terms of the distribution of powers among the institutions, it is therefore sensible to have the national central banks closely integrated into banking supervision.

And I am, of course, also glad to say that the success of central bank operations since August 2007 has certainly not been due just to the efficient division of labour among various institutions. Rather, the Eurosystem’s monetary policy framework has played a crucial part in this.

As I can report from my own experience, but without giving too many secrets away, the Eurosystem has earned a great deal of respect in the international institutions and bodies which are dealing in depth with the financial crisis and the lessons and implications to be drawn from it. A key role in this institutional structure of bodies is being played by the Financial Stability Forum, which our former Bundesbank President, Hans Tietmeyer, had the foresight to initiate within the G7 in 1999. The FSF demonstrated its great value in the crisis as an agency of informal cooperation between national bodies, international organisations and standard-setters. The list of recommendations reached by consensus and adopted by the FSF is now at the heart of the international response to the turbulence. The recommendations are being worked through in stages. A progress report on this will appear in just over three weeks.

Even so, it is undoubtedly no surprise that the international governance of the financial system – as after every global crisis – is now being subjected to critical scrutiny again. If we are thinking about changes, I believe we should strengthen those institutional structures that did their job well during the financial market turbulence. For me, this means that, first and foremost, the FSF should continue to a play key role in terms of responsibility for financial stability. Its widely drawn membership from central banks, ministries of finance, supervisors, regulators and international institutions means that the holistic assessment of the financial system is one of the key strengths of the FSF.

The International Monetary Fund should engage all its forces in the FSF, above all, with an in-depth analysis of the way the financial system interacts with the real economy. For the analysis of these interactions, the IMF can draw on decades of experience in Article IV consultations and a decade of assessments of the financial sector [FSAP]. The IMF therefore has almost ideal conditions for this in place. Despite the financial crisis, however, I do not see any compelling reasons for additional financing facilities at the IMF, which would bring it quite close to performing the tasks of a central bank.

III Fundamental issues of procyclicality

After outlining some fundamental issues in the area of regulation and the institutional structure for safeguarding stability in the financial system, let me now turn to my third key issue, which, internationally, is right at the top of the agenda and, in my view, will also be under discussion for some time to come. Mario Draghi, the governor of Banca d'Italia, made this very clear yesterday evening at our Bundesbank Lecture in Berlin. Basically, the question is whether the regulatory framework for the financial system, as well as the provisions for accounting, act procyclically – and, if so, what can be done to counter that.

To reduce the complexity, I shall interpret the term “procyclicality” quite narrowly for once, namely as a reinforcement of the natural cycle of the financial system. Procyclical policy and procyclical elements of regulation would amplify the natural upswings and downswings of the financial system. If this leads to boom-bust cycles, the functional viability of the financial system is jeopardised.

Naturally, considerable caution is called for when dealing with the topic of procyclicality as we still don’t know enough about the cyclical effects of regulatory provisions. Added to this is the fact that the potential means against any procyclicality have not yet been researched and tested in detail, such as components that dampen procyclicality or even automatic stabilisers in the regulatory framework which are anticyclical in effect. My concern today is therefore quite a modest one. I merely wish to raise even further your awareness of all the issues associated with the proposition that the regulatory framework is procyclical.

To avoid any misunderstanding, I do now wish to stress once more that the regulatory framework with the risk-sensitive minimum capital requirements under Basel II and the use of fair value accounting under IRFS (or US GAAP) does contain cyclical elements. It is unclear, however, how far these built-in elements can also develop procyclical potential. Other experts argue, in turn, that the cyclicality of these two frameworks is a side effect of their desired characteristics. It is claimed that the potential procylicality has been deliberately condoned in order to make the capital requirements risk-sensitive and make capital requirements consistent with market conditions. And, just like you, I, too, have become familiar from this debate with the proposition that the traditional micro view of regulation has gained the upper hand over the macro or systemic perspective.

What is generally agreed in all of this is that the risk-sensitive minimum capital requirements under Basel II are based on probabilities of default, which fluctuate over the economic cycle. In a downturn, probabilities of default increase – along with the minimum capital requirements. Buffers, which are designed to dampen the procyclical potential, have now been built into Basel II. For example, long-term averages are to be used for the probabilities of default and the assigned loss given defaults are also to take due account of scenarios with a potential economic downturn.

So far, it is unclear – and how could it possibly be otherwise so soon after the introduction of Basel II? – whether the cyclical fluctuations of the minimum capital requirements actually impact on the propensity to lend – in other words, whether they really have a procyclical effect. The extent to which this happens hinges on a large number of factors – for example, on how far the capital buffers exceed the regulatory minimum, on the willingness of the banks to let these buffers “breathe”, and, naturally enough, on the use of alternatives, such as raising additional capital. Moreover, not all the fluctuations in actual lending are on the supply side; demand, too, can fluctuate considerably over an economic cycle.

Furthermore, my cautious attitude to the question of procyclicality also has to do with the fact that empirical studies on the impact of risk-sensitive minimum capital requirements need longer time series. Less than one year after the introduction of Basel II in Germany, the database is still very narrow. It is not yet possible to make a detailed assessment of whether the minimum capital requirements are becoming binding and therefore acting in a procyclical manner. Knee-jerk responses, such as the general introduction of additional general capital buffers by means of Pillar 2 are therefore, as we see it, not appropriate.

What is, in fact, called for is a close monitoring of developments and a careful analysis of the incoming data. It is important, first of all, to gain a deeper understanding of the complex mechanisms of banks’ capital management and of Basel II’s impact over an adequate period of time. The banking supervisors are working very hard on this. Their findings, as well as others, can then be used to assess any systemic effects of the prudential requirements. If procyclical effects exist on a significant scale, they should then be taken into account in a system-oriented supervisory approach.

Now, I have already indicated that the fundamental issues concerning procyclicality also have to do with accounting. Fair value accounting leads to valuations fluctuating along with market prices. This evidently heightened the financial market turbulence. With a mark-to-market valuation of the paper, losses result in falling asset values, making the reduction of risk positions seem advisable, thus triggering a further wave of selling. Computer-controlled procedures for automatically limiting losses can give further impetus to this procyclicality. Conversely, rising asset values in an upswing make additional investment possible, which can drive market prices up even further.

Nevertheless, by means of “prudential filters” the banking supervisors have ensured that these fluctuations in the balance sheet items do not impact fully on the regulatory capital. This means that the nexus of falling market prices for assets, declining own funds and restricted ability to lend in a downswing is dampened. In an upswing the reverse applies. This prudential correction mechanism therefore limits only part of the effects of fair-value-based accounting, namely its impact on the potential supply of credit.

IV Conclusion

Ladies and gentlemen
In conclusion, let me return once more to the beginning. After well over a year of financial market turbulence and following the experience of the past few days, I firmly believe that stabilising the financial system cannot consist solely in working through “to do” lists with their recommendations for action, however positive and correct they may be. Rather, a lasting stabilisation of the financial system calls for a holistic policy approach which links the microprudential base – in other words, the perspective on the individual institutions – with the macroprudential perspective and which simultaneously integrates the macroeconomic background and developments in the financial markets.

Realising such as a holistic approach is certainly not an easy task. But I regard it as the right course for arriving at a lasting stabilisation of the financial system.

Thank you for your attention.

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