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How should banking regulation change

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– Es gilt das gesprochene Wort –

I

Roughly speaking, the crisis can be split into three phases:

- Following problems on the US subprime mortgage market, the players lost market confidence in many securitisations and their refinancing, which primarily affected the money markets.
- The crisis peaked with the Lehman insolvency on 15 September 2008. The crisis of confidence engulfed money, capital and credit markets throughout the world and made it necessary for central banks and governments to launch massive support measures worldwide to safeguard liquidity supply and ensure solvency.
- The financial crisis spread to the real economy towards the end of 2008. Since then, governments have been combating this with massive fiscal stimulus measures.

II

The crisis revealed a series of weaknesses in the financial system. A lot of recommendations and proposals for individual measures are currently being put forward and discussed on all issues, some of which do not always appear to be completely devoid of institutional self-interest.
All proposals should therefore be measured against the yardstick of whether they strengthen the sustainability of the international financial system.

Sustainability, a term that was originally coined in ecology, defines a development which does not seek short-term success to the detriment of long-term success. If we translate this to the financial industry, we find a number of practices that did not comply with this principle:

- Sustainability is questionable, for example, in the case of business models based on short-term, variable-rate loans to subprime borrowers, which were immediately securitised and tranched. The business model was based on the hope that the value of the collateral would increase steadily and that market liquidity for securitisations would prove inexhaustible.
- Moreover, quantitative risk measurement methods, such as value-at-risk or expected-shortfall models, which could figuratively speaking be described as "looking in the rear-view mirror" and whose use has increased, have proved necessary but inadequate and should be supplemented by forward-looking instruments such as stress tests and scenario analyses, which also take into account changes in third party behaviour.
- In retrospect, the total – and at times blind – faith in rating agencies and their assessments cannot be justified as the massive downgrading of entire vintages of securitisations demonstrates the instability of ratings across a cycle and highlights the inadequate scrutiny of the assets underlying securitisation products.
- Sustainability is also a question of accounting, which is based to a large extent on current market value: Firstly, if valuations are allowed to shoot up in good times, they will have all the further to nosedive during a downturn. It is a well-known fact that the hangover the day after is worse the wilder the party was the evening before. And secondly, the compass of market value fails if market functions are disrupted.

III

Likewise, it would not be very sustainable if regulators were now to respond to the numerous individual problems by intervening with an equally large number of individual measures. Rather, the strengthened international cooperation that has emerged during the crisis is an opportunity to devise a closed and coherent regulatory framework that sets the right incentives.

- The scope of supervision is all about setting the right incentives; here, the G20 made an important policy decision back in the autumn of last year: all financial market players – including near banks and shadow banks – must be regulated;[1]
- The issue of "incentives" also comprises the past practice of arbitrage between the banking book and the trading book, which the new Basel regulations aim to avoid.
- Ultimately, this includes a review of the rules that allowed the crisis to emerge;
    - eg legal constructions such as non-recourse mortgage loans, which are used in some countries and were instrumental in promoting borrowers' willingness to take out subprime loans;
    - other rules that need to be reviewed are capital requirements for liquidity facilities or the favourable capital requirements for securitisation tranches; major progress has already been made in this field with regard to greater transparency and risk-oriented capital charges. However, the practice of measuring the leverage ratio solely by on-balance-sheet items – as happens in some jurisdictions – also creates incentives to establish off-balance sheet special purpose vehicles.

IV

In order to avoid getting mired in detail, we need to keep our eyes on the big picture in terms of the effects of the many proposals for new rules.

I would like to illustrate this with an example relating to regulatory capital; a whole range of measures are currently being discussed:

- the definition of regulatory capital,
- the general increase in minimum capital requirements,
- a capital add-on for large institutions,
- the introduction of an anticyclical capital buffer,
- the introduction of a leverage ratio and
- greater capital backing for certain complex securitisation positions and the trading book (largely completed).

The big picture should be kept in mind when evaluating the impact the measures will have on the capital situation of institutions; before any final decisions are taken, an in-depth impact study is therefore necessary (and is actually planned according to current documents) to assess the individual proposals' interdependence.

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[1] Statement by the G20 Heads of State or Government of 15 November 2008, Washington.

Even if the origin of the crisis (commercial paper market) and its climax (Lehman) represented a liquidity crisis, the capital debate is essentially right. For strengthening institutions' capital base makes the financial system more robust. Higher capital requirements make it more difficult to build up excessive balance sheet leverage and increase caution towards risky business models, as the owners' liability gains greater weight. Therefore, the debate represents an important step towards preventing the next crisis.

However, that will not end or shorten the current crisis. Although encouraging signs of recovery are emerging, the crisis is not yet over and it will take years to come back to previous levels of output. Rising unemployment, a scarcity of private capital and the pressure to deleverage being exerted by the markets and rating agencies are dampening business and earnings possibilities. At the same time, the deteriorating creditworthiness of many borrowers – euphemistically called rating migration – is hurting banks' ability to lend. In terms of securitisations, this effect is aggravated by the "cliff effects" under the Basel framework (sudden increase in capital requirements triggered by a rating fall below a certain threshold).

The growing use of fair value accounting, strong rating migration and cliff effects under the Basel framework render the financial system to some extent procyclical. Regulators wishing to avoid this having a knock-on effect on banks' ability to lend should therefore not implement capital measures until the crisis has been safely resolved.

V

The crisis provides the historic opportunity to anchor the principle of a social market economy internationally; to provide global "guard rails" for the markets' innovation and dynamism which will ensure system stability and shock-absorb destructive excesses. The key objectives when establishing these guard rails should be

- to strengthen sustainability,
- to steer incentives, and
- to avoid procyclicity.

For the financial sector as for regulators and supervisors, these principles will encourage a reversion to the role of a service industry. On the one hand, supervision is intended to protect creditors, on the other hand, however – when it comes to standards and regulations – it also serves the real economy indirectly by creating a framework allowing the financial industry to fulfil its role as an intermediary.

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