Professor Dr Axel A Weber

President

of the Deutsche Bundesbank

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1 Introduction

Ladies and gentlemen

I would like to extend a warm welcome to you here at this conference dinner which concludes the first day of scholarly exchange on the future of banking regulation.

In the light of the financial crisis, the subject we are dealing with has major priority and, as the agenda shows, is a very broad topic in terms of the issues it covers. Under discussion are questions about the effects of banking regulation as well as institutional aspects of how banking regulation should be organised. Above all, we should keep in mind that banking regulation should reflect the state of development in the financial markets, which implies that it is exposed to constant change. This is revealed, not least, by the history of banking regulation, which I would like to go into briefly before turning to the prevailing deficiencies of banking regulation and the main challenges in strengthening financial stability.

2 A brief history of banking regulation

Safeguarding financial stability – as a prerequisite for macroeconomic growth and prosperity – is the main driver behind banking regulation. Consequently, calls for better banking regulation have typically emerged in the wake of financial instability. In the post-war era, the col-

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lapse of the Bretton Woods system in the early 1970s combined with the oil shocks of 1973 and 1974 raised the first severe concerns about global financial stability. This prompted the central bank governors of the G10 to establish the Basel Committee on Banking Supervision in 1974, which eventually led to the creation of the capital adequacy standards Basel I and Basel II. The initial task of the Basel Committee, however, was not to harmonise international banking supervision, but rather to promote education, information sharing and research in this field.

The need for convergence of supervisory standards, namely those of capital measures and capital standards, emerged as a result of the debt crisis that erupted in 1982. In particular, the fiscal burdens caused by the recapitalisation of international banks and IMF support to economies that were severely affected by the debt crisis led to the call for better banking regulation and a convergence of international standards. In 1988, the Basel Committee published the Basel Capital Accord which had been agreed by its members. The two aims of this 1988 Accord were the same as those for international financial supervision ever since and up to the present day: first, to strengthen the stability of the international banking system, and, second, to eliminate or mitigate distortions in international competition among banks due to differences in national regulation. Undoubtedly, the main achievements of the first Basel Capital Accord were that it represented a significant step towards international harmonisation of banking regulation – it was later applied by more than 100 countries – and that, for the first time, it put the focus on the relationship between the capital that banks hold and the weighted risks that banks take.

After its implementation, it was not long before Basel I came in for increasing criticism. First, it did not adequately cover all the risks to which banks were exposed. Second, the risk weightings were presented in a very crude form that was an inadequate reflection of the actual underlying risks. Despite such early warning signs, it was a long road that led to the implementation of Basel II. In the interim, financial turbulence, namely the Mexican crisis (1994-95) and the Asian crisis (1997-98) had further heightened the awareness among the

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G10 countries of the need for greater international cooperation in financial market oversight. As a consequence, the Financial Stability Forum was founded in 1999 and the first working groups were entrusted with drawing up appropriate measures for financial regulation. Out of this process the Basel II framework with its three pillars that you are all aware of was born and finally published in June 2004.

Basel II was scheduled for implementation by end of 2006. However, owing to its complexity – especially with regard to the different approaches to assessing the minimum capital requirements – the timetable allowed fairly long transition periods for the change of supervisory regime. As a result, Basel II had not yet been fully implemented by most credit institutions when the subprime crisis emerged in the summer of 2007. In particular, many banks – including the EU ones – applied the new Basel II capital rules for the first time in 2008.

Consequently, we still have only a restricted knowledge, based on real data, of how Basel II works in practice. And, most notably, we cannot blame Basel II for the recent financial crisis. Nevertheless, the financial crisis has highlighted deficiencies in financial regulation within and beyond the supervisory framework of Basel II that have to be addressed based on a thorough analysis.

3 Challenges in strengthening financial stability

3.1 Banking regulation

The search for the underlying causes of the financial crisis has been intense. Although a definitive assessment is still outstanding, it is widely agreed that the seeds of the crisis were sown by a whole range of developments at the micro and macro economic levels. For this reason, addressing identified deficiencies in banking regulation and the supervisory process can be no more than a building block, albeit a very important one, for enhancing the resilience of the global financial system.

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The most prominent shortcomings revealed by the financial crisis fall within the scope of credit risk transfer and the expansion of the “originate to distribute” business model that accompanied it. These deficiencies concern insufficient capital backing for securitisations as well as inadequate risk management within financial institutions and a lack of transparency in the whole transfer process. Consequently, the necessary modifications affect all three pillars of Basel II. The Basel Committee on Banking Supervision has responded promptly in the light of these insights, and many reforms are already under way. More specifically, the capital requirements for securitisations have already been raised and stricter disclosure requirements have been published. Both measures will have to be implemented by 2010. Moreover, the Basel Committee has strengthened the guidelines for the supervisory review process under pillar two of the Basel framework and thus addressed key lessons of the crisis with regard to governance, the management of risk concentrations, stress testing, valuation practices and exposures to off-balance sheet activities.

3.2 Procyclicality

In addition to the measures that have already been taken, a number of quite fundamental aspects of the Basel II framework have been subject to review, some of which are also under discussion at this conference. However, most of these aspects concern hitherto uncharted fields of regulation. For that reason, further research is needed to calibrate them adequately.

Most notably, there is an ongoing debate on the design of an adequate capital ratio in order to increase banks’ resilience and ability to absorb losses. This debate is focusing, in particular, on how institutions can build up capital buffers during good economic times in order to cushion losses incurred during poor economic periods. Closely connected to this endeavour is the debate on possible procyclical effects of Basel II.

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Undisputably, Basel II acts in a risk-sensitive manner and therefore responds cyclically to economic developments. However, this is a deliberate and very important feature of Basel II and should not be abandoned. The question is, however, whether or not Basel II acts procyclically in the sense that the increase in capital requirements in times of financial stress or economic downturn is such that the resulting decrease in bank lending threatens to cause a downward spiral or a credit crunch. In the whole discussion on procyclicality, the advantages of the risk-sensitive capital requirements of Basel II should not be forgotten. This is also one of the main findings of the paper by *Repullo and Suarez*, which will be presented at this conference. Assessing the procyclical effects of Basel II in a dynamic equilibrium model, they identify a procyclical tendency of the risk-sensitive capital requirements of Basel II. However, this effect has a pay-off in terms of the long-term solvency of the banking system, which is much greater than under a Basel I regime or in a situation without any capital requirements.

Although there already exists ample research on this question, there are not enough findings yet for an appropriate evaluation of whether or not Basel II has acted procyclically in the current crisis. This is due to the fact that the new Basel II capital requirements, as I mentioned earlier, only came into effect in 2008 in most countries and that, consequently, we have little experience of how they work in practice. Before taking any decisions on possible countermeasures, we should wait for the results of the Basel working group which is currently examining the potential procyclicality of Basel II. Nevertheless, possible options for limiting the procyclical effects of Basel II are already being compiled and research in this field is under way. This is reasonable, not least owing to the complexity of the issue and will enable us to respond quickly when necessary. Possible options for action tend towards a refinement of the risk-sensitive IRB approach of Basel II. For example, the capital requirements could be adjusted counter cyclically using credit growth as an indicator for the state of the economy. In times of high credit growth a surcharge on capital requirements would be prescribed. Slightly different is the proposal *Repullo and Suarez* make in their paper. They suggest a calibration of the confidence levels used in the Basel formula for calculating capi-

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tal requirements. The proposed calibration is such that long-term risk is constant but confidence levels are relaxed in situations where Basel II tends to act procyclically. What the two mentioned approaches have in common is that the risk-sensitivity of Basel II is retained – a prerequisite for any sensible adaption of Basel II.

3.3 Systemic risk control

Apart from observed stress in single financial institutions and market segments, the financial crisis has had a systemic and global dimension which has highlighted the fact that it is not enough to safeguard the stability of each bank individually. If we want to address the causes of the financial crisis in full, supervision has to be taken one step further. In particular, systemic risk has to be identified and guarded against. This raises new questions, such as how systemic risk can be identified and whether the systemic relevance of an institution should be considered by introducing capital surcharges for systemically important banks. Once again these issues, which enter new fields of financial supervision, are being addressed by researchers, and different approaches are under discussion.

When trying to identify systemic risk, a crucial point is to find adequate measures for indicating economic stress. The paper by *Huang, Zhou and Zhu* which will be presented at this conference contains an approach for measuring the systemic risk of a financial system using financial market data. Compared with indicators derived from banks' balance sheets, financial market data have the advantage that they are available on a timely basis and are forward-looking. However, market-based risk measures are much more influenced by market movements than balance sheet related data. Consequently its suitability has to be reviewed more often.

Whereas *Huang, Zhou and Zhu* concentrate in their paper on the identification of systemic risk and the potential downside risk to a group of major financial institutions, *Adrian and Brunnermeier* go one step further in the paper they presented today. In their approach sys-

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temic risk of a financial institution is first identified and then directly incorporated into the regulatory framework. As justified as the intention to regulate banks and financial institutions according to their contribution to systemic risk may be, it is even more difficult to design and implement a rule that puts this into practice. Here, too, it is crucial to identify appropriate indicators of the contribution to systemic risk. The attendant risk – which can never be eliminated entirely – is that regulation focuses in too mechanical a manner on prominent risk indicators while overlooking other, less obvious ones.

Last not least there is a resulting necessity for a permanent revision of the regulatory framework that will allow supervisory authorities to respond flexibly to market developments. This means that the organisational aspects of global financial regulation have a key role to play in strengthening systemic risk control and safeguarding global financial stability. In this respect, the initiatives and action being taken at the European and global levels to enhance macroprudential supervision are to be welcomed. In the EU, the planned foundation of a European Systemic Risk Board (ESRB) – consisting of representatives from central banks, supervisors, and the European Commission among others – is a step into the right direction. However, the ESRB will contribute effectively to systemic risk control only if an unpoliticised open analysis and discussion is ensured. Therefore, central banks should have sufficient representation on this board and be given adequate weight.

There are two more arguments why central banks should play a key role in banking supervision. First, the interdependence of monetary policy and the financial system means that central banks have a strong and natural interest in financial stability. Second, central banks in most countries are strongly involved in banking supervision and can therefore bring their expertise to bear in this field.

Having said that, I do not want to skim over the fact that central banks, too, have their own lessons to draw from the financial crisis. One of the lessons which certainly has to be learned is that the stability of the financial system is an essential condition in its own right

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which has to be taken into account in the conduct of monetary policy. In this context, the paper *Borio and Zhu* presented at this conference points to a very important link between monetary policy and the perception of risk by economic agents – something which has, so far, been neglected. Although more research is undoubtedly needed before we can speak of risk-taking as a new channel in the monetary policy transmission process, major lessons for monetary policy can be drawn from the findings of this paper. In particular, the conclusions support the call for a more symmetric monetary policy that tries to look through the financial cycle in stabilising monetary policy.

4 Conclusion

Ladies and gentlemen

Safeguarding financial stability has been the paramount objective of banking regulation. Unfortunately, it has usually been only the painful experience of financial crisis which has been a catalyst for implementing the necessary regulatory changes. From history and not least from the current financial crisis we should learn that banking regulation is exposed to permanent change, and so the debate on the future of banking regulation must and will go on.

Thank you very much for your attention.

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