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# Making the Financial System more Resilient – The Role of Capital Requirements

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– Check against delivery –




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# 1 Introduction

Ladies and gentlemen

It is said that a good speech has a good beginning and a good end and that the two are as close together as possible. I think this is especially true when it comes to after-lunch speeches which deal with rather weighty and complex issues such as the regulatory response to the financial crisis.

The financial crisis has indeed been one of the most devastating economic events of the past decades. Nevertheless, as the markets have stabilised and recovery has finally set in, the time has come to look ahead. Our main challenge now is to initiate the reforms that are necessary to create a more stable and more resilient financial system for the future.



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## 2 The necessity of enhancing the resilience of the financial system

The first step towards achieving that goal is to gain a clear understanding of the underlying causes of the financial crisis. The crisis is a very complex phenomenon, however. It can be analysed from a vast number of perspectives, each of which can teach us a specific lesson. And it cannot be denied that many of the lessons learned show us that there is room for improvement in the field of financial regulation. Consequently, a lot of effort is being put into far-reaching and ambitious reforms of the regulatory framework. The main goal of these reforms is to make crises less likely in the future. Even so, it has to be acknowledged that such a probability can never be reduced to zero. And this insight brings us to the concept of "resilience". Only a truly resilient financial system will be able to fully absorb the shocks that could not be prevented beforehand.

The most obvious benefit of a more resilient financial system would be to lessen the need for governments to act as lenders of last resort. Although such intervention proved very successful during the current crisis, it generates undesired side effects. The most obvious of these is the burden it places on the state budget. Not only is this a problem in itself, it also leads to other unfavourable outcomes. First, the costs of stabilisation are not borne by those who caused the crisis but by the taxpayers (although there might be a certain overlap, of course). This uneven distribution of costs is certainly not right morally, and it is also fraught with problems from a financial-stability viewpoint. The fact that it is not the originators of the crisis that have to foot the bill induces moral hazard and this, in turn, promotes risk-prone behaviour and increases the likelihood of future crises.

For these reasons alone, it is important to enhance the resilience of the financial system and, by doing so reduce the necessity for public bail-outs. This goal could be pursued by



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strengthening two consecutive lines of defence. The first line of defence would comprise measures that reduce the likelihood of banks failing in the first place. The second line of defence would consist of instruments that reduce the systemic impact of actual or looming bank failures. Let us take a closer look at the relevant measures and instruments that are under discussion.

## 3 Reducing the likelihood of individual bank failures

The most comprehensive proposal to reduce the likelihood of individual bank failures is the reform of capital requirements within the **Basel II framework**. This is based on the assumption that, for the individual institution, capital requirements constitute the central buffer against losses. However, the crisis revealed that the overall level of capital that banks were required to hold was insufficient compared with the magnitude of the losses. At the same time, it became apparent that the loss-absorbing capacity of the capital held was too low.

Consequently, vigorous efforts are being put into adjusting the capital requirements within the Basel II framework. The explicit goal is to promote a more resilient banking sector by raising not only the level but also the quality, consistency and transparency of the capital base. Given the particular risks resulting from the failure of a systemic bank, the introduction of a special capital surcharge for systemic banks is being discussed. This would not only enhance the resilience of such institutions, it would also make it less attractive to become systemically relevant in the first place.



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An outline of the complete set of measures was published in December 2009. Currently, the proposed measures are being analysed in a comprehensive quantitative impact study, and in the course of 2010 they will be calibrated and finalised. Together with new standards for liquidity provisions, the new rules should be implemented by 2012.

A second proposal to reduce the likelihood of bank failures was put forward by the German Council of Economic Experts, and similar proposals have been made by others. The proposal features a **European Stabilisation Fund**. The thinking behind this might initially seem to be not too different from the underlying concept of Basel II. Banks would be obliged to contribute to a fund according to their risk structure and their systemic relevance. Thus, just like the capital requirements under Basel II, a price would be placed on risk-taking, especially if it has a major impact on the system as a whole. However, in contrast to the capital held under Basel II, the resources that are contributed to the fund are lost to the individual banks. Thus, the Stabilisation Fund puts an outright (Pigouvian) tax on risk-taking in order to internalise the effects of risky activities on financial stability.

As an ex post instrument to put a burden on the originators of the crisis, such a tax might be justified. Nevertheless, as an ex ante steering tool, the proposed fund has major shortcomings. First, it would drain capital from banks. But, more importantly, it would not solve the moral hazard problem. As the fund would act as lender of next-to-last resort for failing banks (the government would still have to step in if the fund's resources were exhausted in a crisis), the problem would merely be shifted from the level of government to the level of the fund. The banks, in fact, would still have an incentive to take on too much risk, while relying on the fund to cover potential losses. In the case of a European fund, the moral hazard problem might even be amplified, since costs that would normally occur at the



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national level could be shifted, at least partially, to the supranational level. A systemic crisis might even provoke a rat race among national governments for the fund's limited resources.

While the Basel II framework puts a shadow price on risk, and the Stabilisation Fund puts a tax on risk, a third proposal goes one step further. This proposal – a core element of what is known as the **Volcker rule** – was proposed by President Obama in mid-January. This rule aims at barring banks completely from certain forms of risk-taking: they would not be allowed to invest in or sponsor hedge funds or private equity funds. They would also be banned from engaging in proprietary trading operations for their own profit. Thus, the risk of bank failures would be significantly reduced. At the same time, a cap would be put on the size of banks to reduce their systemic relevance.

One shortcoming of the Volcker rule, however, is that it most likely would not apply to investment vehicles, such as hedge funds or investment banks. And a failure of these could also lead to systemic distortions, as was demonstrated by the case of Long-Term Capital Management or – more recently – Lehman Brothers. Moreover, European experience shows that universal banks with a broad range of business can also be a stabilising factor during a crisis.

However, the most fundamental problem of the Volcker rule lies in the fact that a complete prohibition of certain activities – activities that are perhaps more risky but not necessarily economically inefficient – is a very far-reaching market intervention. The reformed Basel II framework and the Stabilisation Fund also try to restrict possibly destabilising activities but, unlike the Volcker rule, the penalty they impose on these activities is finite. Technically speaking, the Volcker rule enforces a corner solution and, as such, might have unintended



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and unfavourable consequences. It could, for example, have undesirable effects on the transmission of monetary policy.

I have just described three different approaches to reducing the likelihood of failure for individual banks, particularly if they are systemic. These three approaches represent three different levels of intensity. While the Basel II framework puts a shadow price on certain risky activities, the Stabilisation Fund taxes them, and the Volcker rule, as a corner solution, prohibits them entirely. However, as none of the three approaches would be able to entirely rule out the possibility bank failures, they would have to be reinforced by other measures. That is, a second line of defence would have to be drawn.

## 4 Reducing the systemic impact of individual bank failures

If a bank gets into trouble and if its problems threaten to spread throughout the financial system, supervisors have to act quickly. This requires a proper set of instruments and, ultimately, private or public money that can be mobilised at short notice. For this reason, proposals such as the Stabilisation Fund include the establishment of a war chest for financial crises, that is, a capital stock reserved for rescue measures. However, once this capital stock is depleted during a crisis, governments would again have to step in as lender of last resort. Moreover, I have already hinted at the additional moral hazard problems that could result from such a funding solution.

Therefore, a more important supplementary measure would be the implementation of a special **resolution regime** for banks. Such a regime would ensure that even large and systemically relevant banks could fail without triggering far-reaching disruptions within the



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financial system. The crisis has made it perfectly clear that existing bankruptcy law – for example, Chapter 11 in the US – is not well suited to the peculiarities of the financial system and the dynamics of a financial crisis. As a key requirement, a new regime would have to allow supervisors to choose restructuring over bailing-out and thus avoid unfair burden sharing and moral hazard. In this context, a restructuring involving private investors would be the first choice and clearly preferable to direct public intervention. Additionally, the regime should enable supervisors to act swiftly to reduce the risk of bank runs by creditors or clients. And, finally, if the resolution regime manages to separate stabilising the bank from rescuing its owners and creditors, it also reduces moral hazard and thereby the likelihood of future crises.

A related proposal that might be worth discussing is the concept of **"living wills"**. This concept requires systemically relevant banks to produce recovery and resolution plans which set out how operations could be resolved in an orderly fashion. As a result, governments would not have to rescue systemic banks as a whole but only those parts that are important to the economy. Thus, the moral hazard problem would be reduced. However, current bank structures have evolved over many years. Consequently, restructuring as a necessary part of a "living will" would be costly, complicated and time-consuming.

## 5 Conclusion

Ladies and gentlemen

Let me conclude by returning to the very beginning. The title of my speech asks about the role of capital requirements in making the financial system more resilient. The answer is that



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they play a central role as they define the first line of defence in the event of a crisis. Other instruments in this category could be a Stabilisation Fund or the Volcker rule. In my view, both of these instruments have significant shortcomings, however. The best option would therefore be to stick to a revised Basel II framework.

Even so, revised capital requirements alone will not be enough to prevent bank failures. Since the failure of a systemically relevant bank poses a great risk to the financial system, it will be necessary to draw a second line of defence. Here, the most important instrument would be a special resolution regime for banks, particularly if the banks are systemically relevant.

I am confident that the combination of revised capital requirements and a strong resolution regime would significantly enhance the resilience of the financial system. And it is to be hoped that this set of instruments would prevent the last line of defence, that is the government budget and national taxpayers, from once more becoming stretched to the worrying extent we are currently seeing.

Thank you for your attention.

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