DEUTSCHE BUNDESBANK

Dr Andreas Dombret

Member of the Executive Board

of the Deutsche Bundesbank

Beyond the Financial Crisis: Dealing with Systemic Risk

Dinner Speech at the Workshop “Beyond the Financial Crisis: Systemic Risk, Spillovers and Regulation” organised by the Deutsche Bundesbank and Technische Universität Dresden

Dresden

Thursday, 28 October 2010

– Check out against delivery –

Deutsche Bundesbank • Press and Public Relations • Wilhelm-Epstein-Straße 14 • 60431 Frankfurt am Main, Germany
www.bundesbank.de • E-Mail: presse-information@bundesbank.de • Tel.: +49 69 9566-3511, -3512 • Fax: +49 69 9566-3077

Reproduction permitted only if source is stated

Contents

1 Strengthening resilience 2
2 Dealing with systemically important financial institutions 4
3 Macroprudential oversight..7
4 Closing existing information gaps 9
5 Conclusion 11

1 Strengthening resilience

Ladies and gentlemen,

I warmly welcome you to this dinner on the occasion of the workshop, jointly organised by the Technische Universität Dresden and the Deutsche Bundesbank.

This has been a busy day full of research results and models. I would now like to complement this view with some remarks focusing on the policy dimension of systemic risk.

Over the last months, the international community has already decided to improve the regulatory and supervisory framework for the international financial system in several key points. The recent agreement on tighter capital standards (Basel III) represents a particularly decisive step forward in the envisaged reform agenda. The new rules will probably be finally ratified at the forthcoming G20 Summit of heads of state and government in Seoul. Bank capital will have to be stronger and higher in fu-

ture, which will reduce the likelihood of individual institutions failing.

Larger risk buffers in the form of additional capital are not enough, however. More attention needs also to be paid to the “big picture”, the system as a whole. If the crisis has taught us one serious lesson, it is that the tightly networked international financial system can cause events which start out as isolated shocks to rapidly go global and unleash systemic effects.

Such systemic risks can originate in any part of the financial system: channels of potential contagion exist both within financial sectors and markets and across sectors and components. Feedback loops between the financial sector and the real economy can also give rise to systemic risk. The system as a whole can also encounter difficulties if, owing to interdependencies, the rational conduct of market participants at the individual level were to lead to market dislocations in the aggregate.

I draw three direct conclusions from the foregoing, which are related to one another and should be main elements of the policy response to the crisis. First, we need to find a suitable way of dealing with systemically important institutions. Second, the traditional microprudential supervision needs to be supplemented with a macroprudential – or systemically oriented – component. Third, we must close existing information gaps by gathering information on areas of the financial system that have so far remained in the dark – and, in doing so, must pay particular atten-

tion to the so-called shadow banking system.
I will now briefly discuss these three problem areas.

2 Dealing with systemically important financial institutions

How to deal properly with systemically important financial institutions (SIFIs) is one of the key challenges of our reform agenda. The salient feature of these institutions is that they are especially large (too-big-to-fail), or especially highly networked (too-connected-to-fail). This category can also include intermediaries that perform specific functions which cannot be readily assumed by other market participants.

If one such institution encounters difficulties, this may have severe ramifications, snowball into a threat to the entire financial system and impose costs not only on other market participants but on society at large. Therefore the insolvency of such an institution is considered to be unacceptable. Consequently, these banks enjoy an implicit guarantee which often manifests itself as a competitive advantage in the form of more favourable refinancing conditions.

To solve this problem, we need a comprehensive approach which goes beyond the increase in risk buffers recently adopted by the Basel Committee. The G20 has given the Financial Stability Board (FSB) the assignment of finding solutions. For the upcoming G20 Summit in Seoul, the FSB will present to the

heads of state and government recommendations for dealing with SIFIs.

I think it is obvious that global SIFIs should be subject to more intensive supervision than ordinary banks. Creating a more robust financial market infrastructure is also a must. One way of preventing the development of excessive risk concentration in the derivatives market, for instance, would lie in maximum standardisation and settlement through central counterparties. To be effective, this, naturally, would of course require a regulatory framework which ensures that these central counterparties are well capitalised and well run and that they conduct prudent collateral policy.

There is also a broad consensus that global SIFIs should have greater loss-absorbency than mandatory under Basel III. The amount of this additional capital requirement should be based on the potential damage that such a SIFI would cause to the system in an insolvency case; it should be based on that institution's share of the risk to the financial system as a whole. Such a capital add-on will probably be applied in Pillar 2 of the Basel Framework. Capital add-ons are a suitable instrument with which to put a price tag on the implicit guarantee for global SIFIs. They raise capital costs and thus, to a certain extent, offset the competitive advantage resulting from their implicit guarantee. Alongside capital add-ons, the use of "contingent convertibles" is also among the ideas currently under discussion.

However, some important details still have to be cleared up in the coming months regarding the extent of, and instruments for, ensuring higher loss-absorbing capability as well as regarding the overall international approach for dealing with global SIFIs. In all probability, it will not be until next year before some of these points can be wrapped up for good. One great challenge surely lies in the question of how precisely to quantify systemic importance – apart from the 20 to 30 banks for which this is patently obvious – and translate it into action by regulators and supervisors. We also need to take precautions to ensure that SIFIs cannot circumvent the tightened requirements by reorganising the institutional group structure while leaving the risk profile unchanged.

However, we will never be able to fully prevent individual institutions from encountering difficulties and going bankrupt. Therefore, it is incumbent on us to take measures to ensure that a large SIFI can fail without dragging down the overall system with it. It is therefore indispensable that the financial sector has in place its own restructuring and resolution mechanisms since general insolvency laws have often proven inadequate during the crisis. This would significantly enlarge government agencies' scope for action in times of crisis, while at the same time preserving the desired incentive function of giving institutions a door through which to exit from the market – in an orderly fashion! The individual national legislative frameworks should be internationally as compatible as possible, as this is the only way

to ensure that a SIFI can be restructured or resolved without causing major market turmoil.

3 Macroprudential oversight

The crisis has shown us compellingly that traditional microprudential supervision is inadequate to the task of sufficiently addressing systemic risk. This type of supervision primarily aims at ensuring the stability and solvency of single entities but often fails to adequately address the fact that the financial system as a whole is more complex than the sum of its parts. We therefore need to add a macroprudential overlay to single-entity supervision – only by looking at the system as a whole will we be able to reliably identify at an early stage the risks arising from the interplay of financial market actors and potential contagion effects and take countermeasures. This holds both for systemic risk caused by interdependencies within the financial system and for risk concentrations arising from interplay between the financial system and the real economy. At the same time, the goal of macroprudential oversight is the early identification of the build-up of financial imbalances so that countermeasures can be taken.

With regard to giving supervision a more macroprudential focus, several key institutional decisions have already been taken at international and national level alike. Central banks are usually key players in macroprudential oversight. This makes perfect

sense since central banks house a greater concentration of the expertise needed for a systemic perspective than other institutions. They therefore have comparative advantages in terms of information and ability to take action, born, for instance, of central banks' involvement in the responsibility for financial stability, their oversight of payment systems, their monetary policy operations, which bring them in close proximity to the markets, and their involvement in many international bodies and committees.

At this juncture, I wish to confine myself to three examples of institutional reforms already being undertaken; central banks are key players in all of these cases. As an example of international efforts, the FSB and the International Monetary Fund (IMF) have, since 2009, been conducting global Early Warning Exercises twice a year together with central banks. In these exercises, endogenous financial risks and macrofinancial systemic risks are analysed and policymakers are given confidential warnings and recommendations for actions to counteract identified weaknesses.

In the EU, a decisive step with a similar objective has been taken in the form of the recent agreement on the establishment of the European Systemic Risk Board (ESRB). The ESRB and its support structure, based at the European Central Bank, will assume responsibility for macroprudential oversight in the EU beginning in the year 2011. Its objective is to ensure the early detection of stability risks and issue risk warnings or recom-

mendations to the European Union, member states or European or national supervisory authorities.

Finally, here in Germany, the so-called Risk Committee composed of high-ranking delegates from the Bundesbank and BaFin has been established at the end of 2009. It serves as a coordination committee for better integration of microprudential supervision and macroprudential monitoring. At its regular meetings, information on relevant risk areas is exchanged, enabling cross-pollination between single-entity supervision and systemic oversight. The committee's toolkit also includes recommended actions to be taken by the supervisors concerned.

4 Closing existing information gaps

Successful macroprudential oversight is predicated on the responsible public authorities having all the relevant information they need at all times. This requires, in turn, that all systemically important financial institutions, markets and instruments be subjected to reporting requirements.

In this context, the crisis has forcefully driven home the dangers arising from the fringes of the financial system. Many different types of financial activities had been shifted to the shadow banking system and thus to an area that is not really regulated and about which only insufficient information is available. Put simply, the agents in the shadow banking system include all

those intermediaries which, like banks, conduct maturity, credit and liquidity transformation, yet do not have access to central bank liquidity or public sector credit guarantees.[1] Among these are organisations such as structured investment vehicles (SIVs) or conduits which have acquired a somewhat dubious reputation in connection with investments in securitised subprime mortgage loans. Many market participants had previously been completely unaware of the existence of these vehicles and the extent of their activities.

Other members of this grey zone of the financial system include US money market funds and leveraged investors, such as hedge funds. Although these actors were not at the forefront of the current crisis, they still represent a potential source of systemic risk, not least owing to their business relationships with large regulated banks. In individual, tight markets, they can also trigger and significantly amplify market reactions or act as a catalyst for a general reassessment of risks in the financial markets.

This example serves to show that it is the type of business being conducted and not an agent's formal status which should determine the type of regulatory treatment. We therefore also have to address and oversee those agents outside the classical banking system which perform a significant measure of similar intermediation functions, and subject them to adequate registra-

[1] See Federal Reserve Bank of New York Staff Report No 458, Shadow Banking, July 2010.

tion and disclosure requirements. These reporting obligations will not least provide data input for further research on systemic risk and possible channels of contagion.

An internationally coordinated approach is necessary for any possible registration and disclosure requirements, as there is otherwise the danger that risky activities or products could flee to less regulated or entirely unregulated areas of the financial system and, in a crisis, come back to affect regulated markets. In this connection, we have to bear in mind that the recent tightening of banking regulation through Basel III and the envisaged rules governing SIFIs create new incentives to offshore business to the unregulated areas of the financial system.

5 Conclusion

Ladies and gentlemen,

To sum up: the recent agreement to gradually but significantly tighten the capital requirements for banks represents a decisive step forwards in restoring financial stability. This is not enough, however. What we also have to do, in particular, is

- to curtail the systemic risk emanating from SIFIs as effectively as possible;
- to embed awareness of systemic risk in the entire framework of oversight and resolution, and to complement traditional single-entity supervision with a macroprudential component; and

- to widen supervisors’ focus through transparency requirements directed particularly at the shadow banking system.

Thank you for your attention!

*   *   *