DEUTSCHE BUNDESBANK
EUROSYSTEM

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Lessons learnt: The reform of financial regulation and its implications

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1 Introduction

Ladies and gentlemen

I would like to thank you for giving me the opportunity to share with you some thoughts on the challenges of reforming financial regulation. The financial crisis that we have been experiencing over the past four years has held a mirror up to all of us – academics and policymakers alike. It has provided new insights and opened up new perspectives that will have a lasting impact on both economic analysis and economic policy. The overhaul of financial regulation is a case in point. The reforms we have embarked on will lead to a much more elaborate regulatory framework and to a more resilient financial system – a perspective that is of particular relevance for the United Kingdom, which hosts one of the most important financial sectors worldwide. Just to give you an impression of the numbers: in the United Kingdom the financial sector contributed 9½% to gross value added in 2009, compared to 5½% in the euro area and just 4% in Germany.

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Looking back to the origins of the crisis, there is little doubt that an inadequate regulatory framework was its most important cause. Thus, our task is to strengthen the rules to allow for a more stable financial system. In this context, it is essential that the reforms are not just guided by the lessons learnt from the current crisis, since the next one might emerge from a completely different angle. At the same time, it is imperative that the reform is internationally harmonised. The financial system is global, and to prevent regulatory arbitrage national frameworks have to satisfy certain common standards. Acknowledging the need for a global approach, the G20 has drawn up a comprehensive plan to reform international financial regulation with the general objective of making the financial system as a whole more resilient to potential shocks. Nevertheless, we have to bear in mind that the main task of the financial system is to support the real economy and to promote economic growth. This is the backdrop against which the reform of financial regulation has to be discussed. But let us begin by taking a look at the envisaged reforms before tackling the question of how they might influence the real economy.

2 The reform of financial regulation …

2.1 Towards more stable banks: Basel III

The natural starting point for a reform of financial regulation is the individual bank. Making this basic element of the financial system more stable will be an important step towards more systemic stability. In essence, there exist two elements of protection for the individual bank, one being capital and the other liquidity. Capital serves as a buffer against potential losses, and during the crisis it became obvious that regulatory capital provisions were not adequate. Hence, in the future, banks will have to hold more capital of better quality.

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Another major problem during the crisis concerned liquidity. When, after the Lehman insolvency, financial institutions stopped lending money to each other, a number of banks experienced severe liquidity shortages. Their only remaining options were either to sell assets, thereby disrupting the markets further, or to approach central banks as lenders of last resort. In fact, had the central banks not supplied the financial system with liquidity it would have collapsed.

On the basis of these experiences the Basel Committee on Banking Supervision (BCBS) proposed far-reaching reforms regarding capital and liquidity provisions. These rules, known as Basel III, will make individual banks more stable and will constitute a first line of defence against systemic crises. In November 2010, Basel III was endorsed at the G20 Summit in Seoul. Now, it needs to be transposed into national law and applied without falling behind the agreed timetable.

2.2 Too big to fail: Handling SIFIs

Basel III will certainly make banks more stable, but it will never be possible to entirely rule out the failure of individual institutions. Thus, a second line of defence is needed to prevent the failure of individual banks from triggering a systemic crisis. In this context, systemically important financial institutions (SIFIs) are a special issue. SIFIs are banks which are so big or so interconnected that their failure might provoke a chain reaction which could eventually lead to a systemic crisis. Thus, SIFIs have an incentive to engage in risk-prone behaviour and gamble on being bailed out whenever they get into trouble. Consequently, regulation has to be designed to counter such moral hazard behaviour. An initial step could be to introduce some capital surcharge as well as more intensive supervision for SIFIs in order to enhance their stability. However, since failure still cannot be ruled out entirely, minimising

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moral hazard ultimately requires a system that allows an orderly restructuring of SIFIs. Only then will it be possible to credibly bail-in investors and thus impose the necessary market discipline on SIFIs.

In my view, only globally active institutions should be addressed by an international SIFI regime. A pragmatic approach would be to start with a limited number of institutions which are indisputably of global systemic relevance. The Financial Stability Board is currently developing a methodology to accurately define global SIFIs based on criteria such as size, interconnectedness or substitutability. First results of this exercise are expected by mid-2011. The outcome, that is the specific members of this group of global SIFIs, will probably not be much of a surprise. But the issue of how to properly identify systemically relevant institutions becomes increasingly complex and contentious when turning to a lower – for example the national – level and will keep regulators and supervisors busy for some time to come. For this reason, it is a good strategy to focus on the least contentious and at the same time most systemically relevant candidates first.

2.3 Into the light: The shadow banking sector

Basel III and special rules for systemically important institutions are certainly important instruments in safeguarding the stability of the financial system. However, the best dike is of little use when there is a whole ocean at your back. This ocean is the so-called shadow banking sector: the part of the financial system that is not subject to regulation, that has been inviting regulatory arbitrage and that has been a significant amplifier of risk during the financial crisis. With stricter rules for the regular banking sector, there is a clear danger that more and more activities will flow around the newly erected dikes and add to the ocean of unregulated activity at our back, thereby increasing systemic risk. Thus, we have to turn our

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heads, take a close look at the shadow banking sector, understand what is going on there and ultimately control the systemic risks that we have identified.

As a first step it is necessary to define the shadow banking sector. Here, a broad approach is warranted for two reasons. First, the broader the regulatory view, the less room for regulatory arbitrage remains – provided regulation is internationally coordinated. Second, only a broad view allows the regulators to keep track of the constant evolution of the shadow banking sector. For the same reasons, it is imperative to define the shadow banking sector not in terms of entities but in terms of activities. The central characteristic of shadow banks is that they replicate the classic activities of banks: they conduct credit transformation, liquidity transformation and maturity transformation. Given that shadow banks pursue similar activities as regular banks, they accumulate similar risks which might easily become systemic, flooding back into the regulated part of the financial system.

Consequently, as a second step it is necessary to monitor the shadow banking sector to identify potential systemic risks – a task that requires first and foremost enhanced transparency requirements for this part of the financial system, for example with respect to trade in derivatives. As a third step we have to draw up an adequate regulatory framework. One option would be a direct approach whereby the activities of shadow banks are regulated via instruments such as capital, liquidity or disclosure requirements. Another option would be an indirect approach which regulates banks' interactions with shadow banking entities. Potential regulatory instruments could be tighter consolidation rules, higher capital requirements for exposures to the shadow banking sector or limits on the size of banks' exposure to shadow banks. The Financial Stability Board is currently discussing all the options regarding the definition, monitoring and regulation of the shadow banking sector. However, as this is a complex subject and a number of unresolved issues exist, it might

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prove to be a lengthy process. But I am confident that eventually we will be able to adequately monitor and regulate all potential sources of systemic risk.

3 … and its implications: More stability, less growth?

Ladies and gentlemen, I have just sketched the main fields of regulatory reform: new capital and liquidity requirements as well as systemically important financial institutions and shadow banking. However, making the financial system more stable is not an objective in itself. Rather, it has far-reaching implications for the real economy. After all, the financial crisis led to the most pronounced downturn since World War II. Nevertheless, if we wish to make a sound and comprehensive judgement on the future perspective of economic growth, we have to take a long-term view and look beyond the current crisis. In this context, the concept of potential output permits a calm and objective view of the matter. Abstracting from cyclical fluctuations, it covers the medium to long-term trend of GDP and links it to the driving factors for such a time horizon.

To be more specific, it helps to take a simple textbook model of economic growth as a starting point. In such a stylised model, growth is determined by three factors: capital, labour and technical progress. Now, how are these three factors, in turn, affected by the financial system? The first factor – capital – points perhaps most obviously to the importance of the financial system. After all, the financial sector is not only a part of the economy with a distinct value added – although this value added can be quite significant, as in the United Kingdom. Even more importantly, the financial system also plays a crucial role in capital accumulation. However, especially in highly developed economies that typically boast sizeable and sophisticated financial sectors, the role of the financial system goes far beyond

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that of mere capital accumulation. In such economies, the financial system plays a key role in identifying and funding innovations, thus helping to advance the state of technical knowledge and promoting technological progress. For these reasons alone, an efficient financial system is indispensable for growth. In a sense, even the crisis with its massive repercussions for the real economy and its enormous costs illustrates how important the financial system and its stability are for economic performance and welfare.

With that in mind, it becomes obvious that the reform of financial regulation will not only have a profound impact on the financial system itself but will also influence the real economy. The question at issue is whether the reforms strike the right balance between financial stability and economic growth. In fact, the development of Basel III has been accompanied by concerns that tighter regulation might have a negative impact on economic performance by severely restricting access to credit. However, a comprehensive cost-benefit analysis by the Basel Committee on Banking Supervision has revealed that fears of a significant negative impact on growth are unfounded. This is all the more the case given that there will be an adequate transition period before the new requirements enter fully into force, which will give banks sufficient time to strengthen their capital base. This favourable overall assessment of the macroeconomic impact of well-designed regulatory reform highlights the fact that there is no inherent conflict between the objectives of a more stable financial system and of ensuring strong and sustainable growth.

4 Conclusion

Ladies and gentlemen, the crisis has certainly been a devastating event. But it has also presented the chance to make the financial system more resilient. Trimmed down, where

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necessary, to activities with an unquestionable positive net social value added, it can once again be an important driver and catalyst for economic growth. And, in terms of the general future outlook for growth, we should bear in mind that the financial crisis has not impaired major growth drivers. Emerging markets, for instance, will still make great efforts to catch up, and technical progress will continue. Thus, the crisis certainly does not mark the end of economic growth. Rather, what it *has* done is to highlight the importance of *sustainable* growth and the need for supportive policies – in financial regulation, but in many other policy areas as well.

Thank you for your attention.

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