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Rules and tools for capturing systemic risk

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Perspectives on the European Distressed and
Credit Markets
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– Check against delivery –

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Content

1 Introduction

Ladies and gentlemen

This symposium could hardly be more topical. Following on from this morning's contributions on the subject "Perspectives of the European Distressed and Credit Markets", I'm very pleased to have the opportunity to look beyond the credit markets and add a new dimension to the debate, namely that of regulation.

The financial and economic crisis rocked the very foundations of the global financial system and ruthlessly exposed the weaknesses in international financial supervision. In areas where there are a large number of road accidents, the authorities put up additional safety barriers, bring in speed limits or divert the traffic. On top of that, each car has to have a regular MOT. After the major crash that was the financial crisis, many people fear that regulatory reform will lead to an unfettered spiral of regulation. I disagree.

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As a central banker, I would assess the impact of this reform package by whether we succeed in strengthening the resilience of the financial system. Ideally, the result of this process should be enduring and should not trigger any negative side-effects, eg on competition. But there is a long and arduous road ahead. And it will entail costs for the banking industry.

2 The international reform agenda: What have we already achieved?

As an example of what we've already achieved, take the key points of the reform framework already adopted at international level: "Basel III", a far-reaching new global regulatory standard for bank capital adequacy and liquidity that was endorsed by the G20 at the end of 2010. Its objective, in brief, is to better equip banks for weathering future stress situations. The European Commission recently published a legislative proposal to translate the Basel III rules into EU law, which will affect over 8,000 banks. The Commission cited the IMF's loss estimates in its justification for this move. According to these estimates, crisis-related losses between 2007 and 2010 incurred by European banks alone were close to €1 trillion, or 8% of EU GDP.[1] Given this situation, we must not postpone the global implementation of Basel III; that would send out the wrong message. The Bundesbank welcomes the fact that Europe is playing a pioneering role in this area. The other G20 countries would be wise to avoid delays to or departures from the agreed Basel III implementation plan. In the interests of stability and competitiveness, ensuring that the Basel III rules come into force at the same time in all countries is just as vital as ensuring that they are implemented consistently at a global level.

1 European Commission, press release: Commission wants stronger and more responsible banks in Europe, 20 July 2011.

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In Europe, Basel III will apply to all credit institutions. Going back to the traffic analogy, all road users have to follow the highway code. The fact that another cornerstone of the reform agenda affects the large, systemically important financial institutions, or SIFIs, is therefore very important. They are the heavy goods vehicles – or even the super trucks – of the banking world; their size means that any accident they are involved in can cause gridlock on the roads. These SIFIs will have to obey stricter rules in future; one of the most important is that SIFIs will have to meet higher capital requirements than all other market participants. Some say that the regulatory reforms are forcing small banks to pay for the mistakes of the big banks. I disagree.

Many countries felt impelled to rescue some of these institutions with huge sums of taxpayers' money in order to avoid a systemic collapse. The problem of banks that are “too big to fail" and the moral hazard that this entails are to be remedied by establishing a specific supervisory framework for SIFIs. We should not forget that, just as cars primarily serve to transport people, the financial sector also has to serve the real economy.

In July 2011 both the Basel Committee on Banking Supervision and the Financial Stability Board, or FSB, published a consultative document[2] which is an important step forward. The member states have agreed on a methodology for assessing the systemic importance of banks. In addition, special capital surcharges above the minimum capital requirements will be imposed on SIFIs. The more systemically important a bank is, the higher its SIFI capital surcharge will be. After evaluating the more than 40 commentaries to the consultative

2 BCBS: Global systemically important banks: Assessment methodology and additional loss absorbency requirement, July 2011.

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document it is clear now that the Basel Committee has done a very good job. Aside from a few adjustments and updates to the underlying data, which are already underway, the document is ready to be submitted to the G20 for approval at their summit this November.

The agenda for financial reform also regards a consistent implementation and surveillance of international standards as crucial to its success.[3] FSB peer reviews are one means of achieving this. FSB members are to ensure that standards are implemented as strictly and consistently as possible following the principle “leading by example”, ideally triggering a “race to the top”.

One example of this kind of peer review are the remuneration standards. No one, not even the managers themselves, would dispute that misaligned remuneration systems for bank managers at least played a role in worsening the financial crisis.[4] The G20 countries therefore adopted the FSB Principles for Sound Compensation Practices as early as September 2009 and, on this basis, specific implementation standards.[5] The Basel Committee has since incorporated the disclosure requirements specified in these standards into Pillar 3.[6] Germany was one of the first countries to implement the standards. The Regulation Governing Remuneration at Institutions, or *Instituts-Vergütungsverordnung*, came into force in Germany on 13 October 2010. This regulation takes account of both the international regulations and the subsequent EU provisions.

3 See FSB, Framework for Strengthening Adherence to International Standards, January 2010.
4 This is confirmed by one source from the banking industry itself: IIF, Compensation in Financial Services: Industry Progress and the Agenda for Change, March 2009.
5 FSB, FSF Principles for Sound Compensation Practices, April 2009; FSB, Principles for Sound Compensation Practices – Implementation Standards, September 2009. At EU level, provisions governing remuneration were incorporated into the Capital Requirements Directive III and corresponding guidelines on compensation requirements.
6 BCBS: Pillar 3 disclosure requirements for remuneration, July 2011.

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3 What progress have we made on …

3.1 … restructuring and resolution regimes for SIFIs?

However, the international supervisory community still has much to do in the field of restructuring and resolution procedures for SIFIs. In a free market economy, we cannot and should not ever fully rule out the possibility of a specific financial institution collapsing. The insolvency procedures in individual countries have during the crisis proved to be insufficient – particularly for cross-border institutions. We must make it possible for SIFIs to undergo an orderly exit from the market without the use of taxpayers' money. Only credible resolution mechanisms can eliminate the market's rescue expectations – which means that having systemic importance must not be tantamount to being "too big to fail".

The more than 60 sometimes opposing commentaries in the FSB's public consultation[7] on this issue have been carefully reviewed. The resulting "Key Attributes of Effective Resolution Regimes for Financial Institutions" will very likely be ready for endorsement by the G20 leaders in Cannes. Yet, the G20 countries must take account of the fact that the European Commission is currently working on a legislative proposal[8] on the same issue. In my view, we need to strive for international consistency between the G20- and the European framework.

7 FSB, Effective resolution of systemically important financial institutions – Recommendations and Timelines, Consultative Document, July 2011.

8 EU press release of 6 January 2011, Commission seeks views on possible EU framework to deal with future bank failures. The Commission announced that it intended to make the legislative proposal before the summer of 2011; it is now expected to be published this autumn.

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Germany was quick off the mark in creating possibilities for winding up SIFIs. The Restructuring Act, or *Restrukturierungsgesetz*, which recently came into force in Germany, provides for all banks – regardless of their size – to be either restructured or wound up in an orderly procedure. In addition, the whole of the banking sector has to pay a bank levy which feeds into a Restructuring Fund so that the sector shares in the costs of overcoming future financial crises. It is estimated that the bank levy will channel around €1 billion per year into the Restructuring Fund, and the levy rate to be paid by each institution depends on its systemic importance – an aspect which I expressly welcome.

However, it is vital that we do not overburden financial institutions. I am therefore unenthusiastic about the plans to introduce a financial transaction tax. Much as I get the moral arguments for such a tax, setting the wrong incentives often means that the harm caused in practice outweighs the intended benefits – particularly when measures are not introduced internationally, which encourages business to migrate. We need to have a level playing field across the globe, especially within the EU.

3.2 … the shadow banking system?

Ladies and gentlemen, how would a traffic authority react if there was a sudden spate of accidents involving vehicles that weren't – and still aren't – obliged to have an MOT purely because they aren’t technically defined as cars? This is more or less what happened with the shadow banking system in the financial sector. First, I would like to stress that bank-like transactions outside of the banking sector should not be regarded as a bad thing *per se*. There can be advantages to certain activities being carried out by specialist enterprises rather than banks. The shadow banking system should not be considered the “villain of the piece”, and I would not wish to support this standpoint.

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The crux of the matter is to ensure that financial supervisors have sufficient information to promptly identify risks to financial stability originating from the shadow banking system. Containing risks emanating from the shadow banking system might well require regulatory changes. In particular, we need to avoid regulatory arbitrage at all costs, since we can expect activities and risks to be shifted away from the banking system in response to stricter bank regulation. I would therefore like to stress my support for greater transparency. Of course, I’m aware that reporting obligations engender costs. But, as every economist knows, there’s no such thing as a free lunch. And I believe that the objective of financial stability justifies the costs that such obligations entail. The relevant authorities should therefore be entitled to impose reporting obligations on market participants – and this means all players that could be a source of systemic risk.

So which participants are we talking about here? The FSB defines the shadow banking system as “credit intermediation involving entities and activities outside the regular banking system”. These can be non-bank entities, such as special purpose vehicles or money market funds. Hedge funds can also constitute links in a chain of intermediation outside the banking sector – after all, they collect funds and invest them in bonds and other credit instruments, including derivatives. But the FSB’s definition of the shadow banking system isn’t confined to participants; it also includes activities, such as securitisation.

Work towards addressing the issue of shadow banking is progressing well; this autumn, the FSB will submit recommendations to the G20 in a report focusing primarily on closing gaps and loopholes in transparency and regulation; these recommendations will have to be fleshed out next year. Again, I would like to stress that the oversight and possible subsequent regulation of the shadow banking system is primarily about the systemic risk that can arise in the shadow banking system.

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4 What still needs to be done?

There is another lesson to be learned from the financial crisis: The pre-crisis supervisory approach of focusing mainly on individual institutions proved insufficient. It has to go hand in hand with macroprudential oversight, which aims to identify systemic risk and regulatory loopholes at an early stage so that countermeasures can be taken swiftly. To achieve this, we need, in particular, to improve the underlying information and data – as the situation in the shadow banking system illustrates.

In keeping with the international standards that are currently being elaborated, Germany's governing coalition proposed expanding the macroprudential oversight of the German financial system at its central bank. I understand that work is underway to draw up legislation based on this proposal – a development which I very much support.

Central banks are especially suited to the macroprudential aspects of financial supervision because they already have a duty to maintain a constant overview of market developments. As I've already mentioned, central banks are also aware of the side effects of regulatory initiatives. For example, central bank experts analysed the macroeconomic impact of the transition to Basel III in detail before it was adopted.[9] An extended study on the implications of the planned SIFI capital surcharges provisionally concluded that they can be expected to have only a relatively small negative impact on economic growth beyond the planned implementation period.

9 Macroeconomic Assessment Group (FSB / BCBS), Final Report, Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements, Bank for International Settlements (December 2010) at http://www.bis.org/publ/othp12.htm.

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In my view, it is generally important to look beyond the traditional confines of supervision when addressing these issues. This applies, for example, to the question of how recent international regulatory initiatives are affecting the refinancing conditions of domestic banks. It is not only the credit rating agencies' assessments which suggest that factors specific to individual institutions – such as their capital, balance sheet structure and business models – are the primary influence on banks' individual financing costs. Such factors tend to outweigh the effects not only of the macroeconomic setting, for example, but also of the costs caused by regulation. All in all, the large number of regulatory proposals, as well as their complexity and the rather unfinished nature of some initiatives, make it difficult to assess the overall picture. Ultimately, however, the competitive situation and bank-specific factors are likely to be the decisive factors affecting banks' refinancing conditions.

5 Closing remarks

Ladies and gentlemen
Central banks and financial supervisory authorities face a difficult balancing act. On the one hand, in view of the objective of safeguarding stability, the institutional and regulatory framework has to be tightened and harmonised internationally. On the other, the new rules must not overburden market participants, and the effects of regulation, including its impact on competition, must be evaluated from a macro perspective.

However, the supervisory rules can only set the framework in which financial transactions take place. Market participants themselves must do their part to strengthen the financial system – by improving risk management, for example.

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I would propose that we central bankers and financial supervisors work through our agenda item by item and you, as representatives of large institutional investors, work through the tasks that you have to address. Since we drive on the same roads, so to speak, I look forward to continuing this dialogue with you. A good dialogue is the best way of avoiding any more collisions in future.

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