

## **Axel A Weber: Finance after the turmoil – shape of markets and regulation**

Opening statement by Professor Axel A Weber, President of the Deutsche Bundesbank, for the panel discussion "Finance after the Turmoil: Shape of Markets and Regulation", at the 18th Frankfurt European Banking Congress, Frankfurt am Main, 21 November 2008.

\* \* \*

### **1 Introduction**

Mr Ackermann,  
Ladies and gentlemen

The decision to run this panel under the title "finance after the turmoil" proves that the organisers belong to the more optimistic camp. And like most optimists over the past months, they have been proven wrong. Of course, for a forward-looking policy process it is essential to learn from current events to build a sustainable future. This work on lessons learnt is ongoing in several international and national fora.

The Bundesbank is making every effort to play a constructive role in these processes, and, thus, it is a pleasure and an honour to share with you some thoughts on finance after the turmoil, even though times are still turbulent.

Current challenges are twofold. The first aspect is crisis management and focuses on the resolution of institution-specific problems as regards liquidity and solvency. Moreover, it also concerns financial system rescue packages, their implementation, application and international coordination.

The second challenge is to use the current window of opportunity to bring about lasting structural changes regarding the regulation of financial markets. The aim of such changes ought to be a financial system that is more resilient to the kind of disruptions that we are currently observing.

I would like to share with you some thoughts on crisis management – especially from a German point of view – and on crisis prevention – the latter, of course, in a more international context.

### **2 Crisis management**

As you all know, it was the insolvency of Lehman Brothers that led to the dramatic intensification of the financial turmoil. As an aside, there seems to be a broad consensus that allowing this bank to go bankrupt was a mistake in view of the ensuing heavy losses.

Owing to a rapid rise in counterparty risks following the Lehman insolvency, wholesale funding markets almost completely dried up causing a number of financial institutions that relied heavily on wholesale funding to run into serious difficulties. Furthermore, financial market participants were forced to fire-sell assets thus amplifying market losses.

After taking emergency rescue action for single institutions and in light of escalating worries among depositors, it became apparent that this systemic crisis needed a more systemic response. Many countries implemented financial market rescue plans and comprehensive deposit guarantees – after some initial stand-alone initiatives such moves were coordinated internationally. While the specifics of these packages may differ, they often share a common feature – their dual approach of promoting liquidity and solvency.

The German rescue package is also aimed at these two goals. Its core instrument is a Financial Market Stabilisation Fund.

In order to eliminate liquidity shortages and to support refinancing in the capital markets, the Fund is authorised to guarantee, for a suitable fee, newly issued refinancing instruments with maturities of up to 36 months. The Fund may also purchase shares or dormant equity holdings of financial institutions in order to recapitalise them. Finally, with the option of acquiring problematic assets, it can improve capital ratios too.

The authority that administers the Fund has been set up at and by the Bundesbank, although it is organisationally totally separated from us. It is now fully operational.

After initial reluctance, a growing number of banks, both from the private and the public sector, have asked the Fund for help. An important feature of the Fund is that it is voluntary. Private banks, in particular, obviously feared being stigmatised after engaging the Fund. However, market reactions have shown that such fears were not justified.

Another important feature is its package character. Using only the guarantee scheme is generally not intended.

It is of the essence that banks raise their capital buffers in order to improve their resilience against further downward pressure and to regain confidence. In the current situation, capital adequacy certainly requires more than just compliance with Basel rules. Internationally competitive levels should be targeted, while it does not matter how this will be achieved, whether by means of private or public funds.

Making of public funds, however, should be as temporary as possible. Having said this, it is obvious that every single public capital injection should not only imply suitable compensation but clear exit procedures as well. While such far-reaching intervention by the state in the economic system was unavoidable, it is not a permanent solution.

### **3 Crisis prevention**

There has been a lot of talk about the causes of the current crisis and I do not want to delve into this discussion for the moment. In a nutshell, the current crisis is the result of both market failure and regulatory failure.

Intensive root cause analysis for more than a year has revealed numerous shortcomings in the financial system signalling a comprehensive need for action. As regards regulation, there is presently major political pressure “to do something” in order to reduce the probability of similar disruptions in the future.

However, rather than more regulation we should aim at better regulation. Self-regulation, anyway, has proven insufficient.

A lot of thought has been given to necessary consequences. Considerable efforts have already been made. Last weekend's Washington summit on Financial Markets and the World Economy has certainly taken another important step forward in this respect.

The Financial Stability Forum – being key in this regard – had submitted a comprehensive list of recommendations for strengthening the financial system. Much progress has already been made in this respect.

Instead of analysing the details, I would rather give some general remarks as regards the future shape of regulation.

The first is, we need more transparency concerning unregulated business areas and markets, including hedge funds, OTC traded derivatives or off-balance-sheet vehicles. Gaps on the world map of regulation should be filled.

On the other hand, we should not throw out the baby with the bathwater! We should especially refrain from blanket judgements on discredited financial instruments. To mention just one example, securitisation can be essentially a useful financial technique. Another

important issue regarding the future shape of regulation that I would like to mention is mitigating the procyclicality of financial regulation.

Procyclicality means the reinforcement of the natural cyclicity of the financial system, thereby – in the least favourable case – encouraging boom and bust cycles. Capital requirement rules under Basel II, for example, are supposed to be procyclical owing to accelerating capital requirements in case of rising borrower's default risk. To the extent that banks change their lending behaviour in reaction to this, economic cycles can be amplified.

Another case in point is management remuneration, in particular, schemes that reward quick success with annual bonuses without penalising long-term adverse consequences of decisions that had been taken.

Furthermore, accounting rules have come under scrutiny as regards procyclicality. While fair value accounting certainly has its merits, it amplifies the cyclicity of leverage. Recent amendments in international accounting rules are useful in order to protect banks' current results from further crisis-driven exaggerations. One-sided easing of accounting rules, however, entails the risk of sowing the seeds of a growing risk appetite in the future. As an economist, I suppose, it has become obvious that accounting is too important to leave it to the accountants.

Future regulation of financial markets will significantly curtail too risky business behaviour. Taking recent rises of financial market participants' risk aversion into account, a more stable financial system can thus be expected. Banking in the future might be more boring and less sophisticated, however, it will be more sustainable.

What we should refrain from is

- a) creating new international institutions. Instead we should promote essential improvements of cooperation among existing ones, and – if warranted – assign new tasks to them.
- b) Invest too much hope into crisis prevention by means of an institutionalised early warning system as its utility seems to be overestimated. As you know, there were plenty of warnings concerning unsustainably low levels of risk premiums, sent by central banks and other organisations, but these fell on deaf ears,
- c) Measures of protectionism. Fortunately, the heads of state of the G 20 have declared that they will resist the temptation to protect their national economies at the expense of other nations. However, I hope that these are not just empty promises.

#### **4 Central banks**

Before I conclude, I would like to add some final remarks on central banks and their future role as to financial stability.

Central banks are affected in many ways by the current crisis. Three issues are of major importance in this respect. Firstly, in many countries, central banks are responsible for banking supervision and therefore concerned with the liquidity and solvency problems of individual financial institutions. Even during a systemic crisis, the close connection between central banks and banking supervision has proven to be advantageous owing to synergy effects of micro and macro-prudential analysis.

While the German model of a dual banking supervision system has proven to be effective, international cooperation among financial supervisors needs further improvement. Colleges of supervisors for internationally active categories of banks are a good first step in this regard.

Secondly, being a "liquidity provider of last resort", central banks are concerned with tensions on the money markets. Since the beginning of the subprime crisis, central banks have been

providing commercial banks with comprehensive liquidity measures. After the Lehman collapse and the subsequent drying-up of wholesale funding markets, these operations have been further intensified.

The Eurosystem has repeatedly declared its intention to continue its generous supply of liquidity as long as necessary. However, underlying solvency problems – while not always clearly separable from liquidity problems – cannot be solved by central banks or banking supervisors. It is a core government task, and the German Financial Market Stabilisation Fund is designed to do just that.

Finally, monetary policy has to keep the balance between price stability and financial stability. Central banks have responded to the intensification and broadening of the financial turmoil due to its impact on the real economy with considerable monetary easing in order to support the real economy in view of an increasing room to manoeuvre due to the decline of inflation rates and inflation expectations.

Owing to a remarkable decline in inflationary pressure in the medium term and rapidly deteriorating economic prospects, euro-area monetary policy in my view has enough leeway for further easing if necessary.

But let me voice a concern. Substantially easing monetary policy in the short term to deal with the effects of a bursting financial bubble on the real economy entails the obligation to normalise monetary policy again more swiftly than in the past in order to prevent new imbalances from emerging.