Axel A Weber: Institutional responses to the crisis and thoughts on regulatory issues

Introductory remarks by Professor Axel A Weber, President of the Deutsche Bundesbank, at the Central Bank of Luxembourg conference "Financial Stability and Banking Regulation in Germany and Turkey", Luxembourg, 3 November 2009.

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1 Introduction

President Mersch
President Yilmaz
Ladies and Gentlemen

First of all, I would like to thank you for the opportunity to speak to you here today on financial stability and banking regulation from both a German and a euro-area perspective. I would like to focus on two issues. First, the institutional responses to the crisis, especially from a central banker's perspective, and second some thoughts on the regulatory issues currently being debated, in particular capital requirements.

2 Institutional implications of the financial crisis

One of the lessons of the financial crisis is that a more systemic approach to financial markets is needed. But what does that mean for central banks? I would like to raise three topics.

Firstly, the pursuit of financial stability will have to be taken into greater consideration in the operation of monetary policy. The mandate of central banks is usually to maintain price stability. In the case of the Eurosystem, this is our primary objective. The same applies to the Central Bank of the Republic of Turkey. However, price stability and financial stability are interconnected. Disruptions to the financial markets have negative implications for price stability as they have adverse effects on the economic cycle and distort the monetary transmission mechanism.

That is not to say that financial stability should become an explicit target of monetary policy. It is still true that monetary policy is a rather blunt tool when it comes to combating asset price bubbles. Furthermore, one should not over-estimate central bankers' ability to identify asset price bubbles in advance and to determine whether asset price booms have benign or malign reasons. However, financial market developments should be given greater weight when assessing risks to price stability. Financial crises increase the volatility of macro-economic variables such as inflation and growth. For this reason, it is of the essence to use a suitable analytical framework. The two-pillar strategy of the Eurosystem's monetary policy with its prominent role for long-term-oriented monetary analysis is certainly a good basis. Especially during the financial crisis the often-criticised and sometimes ridiculed monetary and credit analysis has proved valuable in monetary policy analysis.

Nevertheless, the analysis of monetary and credit aggregates must be developed further in order to identify undesirable developments on financial markets. Eurosystem staff are currently working towards this goal. Recent IMF research, for example, has shown that, since 1985, house price busts have typically been preceded by significant upward deviations of the credit-to-GDP ratio from its long-term moving average.

Monetary policymakers should also consider the impact their actions have on financial market participants' appetite for risk. This is why I have repeatedly called for a more symmetrical approach that would treat boom and bust episodes not as isolated events but would try to look through the financial cycle in order to steady policy.

While I am opposed to enhancing the mandate of monetary policy and setting financial stability as an additional and independent target, I am in favour of strengthening the role of central banks in this area. This is the second topic I would like to raise. Calls for a more systemic approach are mainly addressed to central banks. Taking into account the wide range of information and data central banks collect in fulfilling their mandate, no other institution is better suited for taking the systemic macro-prudential view. Central banks combine macroeconomic analysis with deep insights into the financial markets stemming from monetary policy as well as payment operations and – in many cases – data from banking supervision. It is therefore obvious that central banks are key when it comes to macro-prudential supervision.

In the Bundesbank, we have decided – as have many other central banks – to establish a financial stability department in order to give this area of increased importance an organisational home. The new department commenced its work in the middle of this year.

Reflecting the pivotal part central banks play in macro-prudential supervision, the ESCB, consisting of the ECB and the national central banks, will play a leading role in the European Systemic Risk Board (ESRB), which is to be established in the next few weeks. The ESRB will be responsible for the macro-prudential oversight of the financial system of the European Union in order to prevent or to mitigate systemic risks to financial stability.

Thirdly, as I mentioned earlier, central banks are partly or fully in charge of banking supervision in many countries. The central banks of Luxembourg and Turkey do not have responsibility for banking supervision. However, in Germany the responsibility for banking supervision has traditionally been shared by the Bundesbank and the Federal Financial Supervisory Authority, or BaFin for short. BaFin was created some years ago by the merger of the federal offices responsible for the supervision of banking, securities trading and insurance. The operational tasks have mostly lain within the Bundesbank's remit, while BaFin is responsible for all sovereign measures.

As you probably know, the new coalition of Christian Democrats and Liberals recently decided to entrust the Bundesbank with banking supervision. Incidentally, giving central banks more responsibility for banking supervision is currently being debated in other countries, too. I would like to take this opportunity to make some remarks on this issue in the German context:

Firstly, collaboration between the Bundesbank and BaFin has worked well, both before and during the crisis. Secondly, the Bundesbank did not ask to be given full responsibility for banking supervision. Rather it was an objective of the political parties that have won the federal elections.

However, the Bundesbank recently declared its readiness to take on more responsibility for financial supervision if this is politically desired. Still, it is of the essence that the future system be compatible with the independence of the Bundesbank, which is laid down by the EU treaty. We believe this is possible. Nevertheless, in our opinion, the new German government would be well advised to closely consult the Bundesbank in the decision-making process at an early stage. In any case, the Eurosystem will have to be consulted before the law is changed.

Supervision of the financial system will have to become more systemically-oriented in the future. This implies that the interconnectedness of financial institutions must be taken into consideration.

3 Regulatory issues

Institutions matter. However, it would be very unwise to believe that the creation of new bodies at the European or global level and some institutional reform alone will prevent the reoccurrence of a similar crisis. Ultimately, it is the regulation of financial markets that matters when it comes to creating a more resilient financial system.

Basically, making the financial system more stable is a manageable task. The real challenge is to make it more stable without significantly hurting economic productivity. Remuneration schemes, currently a hot topic among the public, are a good example. The disincentive effects of bonuses in terms of short-termism and excessive risk-taking might be prevented by imposing statutory caps on salaries or limiting tax deductibility. However, if interventions are too far-reaching, they may have other disincentive and adverse effects. Therefore it is important to find the right balance. The principles of sound compensation, which were formulated by the Financial Stability Board (FSB) and are now being transposed into national legislation in the G20 and other countries, strike this balance, in my opinion.

Creating level playing fields is another important demand when it comes to seriously improving regulation. Therefore it is of the utmost importance to further promote the convergence of international and US accounting standards, unless we want to continue to compare apples and oranges. However, in this context I appreciate that the IASB (International Accounting Standards Board) has recently agreed to refrain from broadening the Fair value principle in the IFRS.

Strengthening banks' capital base is certainly the most important, but also the most difficult, task on the regulatory reform agenda. Being involved in the processes of the Basel Committee and the FSB, the Bundesbank appreciates the decision by the G20 to improve the quality and quantity of banks' capital once the financial system has stabilised on a sustainable basis and the economy has recovered. However, we should refrain from unsettling the markets with precise schedules. Getting it right is important.

The impact study of the new capital measures of the Basel Committee on Banking Supervision, which is planned for 2010, should provide some enlightening information. As regards the introduction of a leverage ratio, we are afraid of competitive distortions, in particular owing to differences in accounting standards. We therefore welcome the plan to apply this risk-insensitive measure (at least temporarily) under pillar 2 of Basel II. Basically, we are against deviating from the principle of risk-sensitivity in the Basel framework. In this regard, the commitment of all G20 financial centres to adopt Basel II by 2011 has been a very positive outcome of the Pittsburgh summit.

The implementation of a high level, and better quality, of capital requirements in the long run, counter-cyclical capital buffers and higher capital requirements for risky products and off-balance sheet activities are not only in the interest of the public, they should also be in the interest of the banks themselves. On top of that, banks should make greater use of the options they already have to strengthen their capital base, be it by withholding profits or raising private or sovereign capital.

4 Conclusions

Let me conclude.

Financial stability is not just a buzzword as some critics suggested a few years ago. The financial crisis has proven them wrong. Policymakers have shown their commitment to take decisive steps in order to make the financial system more stable. Now it is up to the central banks and the other players in macro-prudential supervision to enhance the analytical instruments needed to recognise risks to financial stability earlier and more accurately.

Thank you for your attention.