Nout Wellink: Rebuilding the financial sector

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Colloquium of the Centre for Financial Studies, Frankfurt am Main, 8 December 2010.

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Introduction

1. Ladies and gentlemen, the financial crisis that has raged since July 2007 is a many-headed monster. At its core is a lack of market confidence in financial institutions and in some countries. I will speak about the background to the global financial crisis, its impact, and about the current situation in some European countries. I will elaborate on some challenges we face for the future. In particular, I will focus on strengthening the resilience of the banking sector, including the approach towards too-big-to-fail banks. I will conclude with the initiatives to enhance macro-prudential supervision.

Causes of the global crisis

Global fire fuelled by interdependencies, …

2. After the first signs of difficulties with subprime mortgages in the United States emerged in the summer of 2007, they were long thought to be a specific US problem that would only indirectly affect other parts of the world. That proved an illusion: the mortgage problem in the US was the spark that set the system on fire worldwide. The flame was kindled by the negligent contracting of mortgage loans, via risky constructions and poor documentation. The popularity of financial innovations generated an opaque pyramid of financial risks that became steadily more unstable.

… and insufficient buffers

3. The innovations enlarged the net leverage in the system, because they enabled banks to operate with an ever slimmer capital position; the ratio between assets and capital at large banks before the crisis averaged out at more than 30. The supervision of liquidity risks at banks was inadequate and fragmented, also in Europe. In addition, the innovations deepened the interdependencies between financial institutions, and hence the pace and scope of contagion channels. In other words: the fuel to start a great fire was omnipresent. The crisis eventually erupted with great force after the collapse of the US investment bank Lehman Brothers in September 2008. The losses caused by that collapse and the major uncertainty about who exactly was hit, led to a disappearance of market confidence and a full-blown systemic crisis.

Global imbalances contributed to indiscipline

4. Although the relative importance of the various causes is subject to debate, there is now a rather broad consensus about the developments that led to the crisis. The globalisation and integration of some parts of the global economy, like China and Eastern Europe, that had thus far been isolated was coupled with the build-up of global imbalances. Excessive debt build-up in Western, notably Anglo-Saxon, countries went in tandem with huge surpluses in oil-exporting countries and Asian countries. Asian countries stuck to a stable currency, causing the imbalances to continue and their currency reserves to accumulate. The investment of these reserves in the US kept US interest rates low, the so-called global savings glut, contributing to financial indiscipline in that country.

Loose monetary policy another cause

5. The accommodating monetary policy, particularly in the US, sowed the seeds for the imbalances. In the years before the crisis, money supply growth well outpaced potential GDP growth. This was not reflected in mounting inflation, because the supply of relatively cheap products from Asia kept price rises moderate. Nonetheless, the monetary expansion resulted in an acceleration of asset prices and credit aggregates. Before the crisis, lending in industrial countries grew by around 10% annually. The low interest rates and the abundant availability of credit encouraged a search for yield. Risks were underpriced and bubbles could easily arise, especially in real estate. This was the case in the US but also in some European countries. With hindsight, the interest rates were too low to tame the monetary expansion and other, more macro-prudential, instruments should have been deployed to contain the credit expansion.

What has been the impact of the crisis?

Serious damage in financial sector, partly at governments' expense

6. Writedowns on securitisation products and on ordinary loans led to huge losses in the banking sector. Banks worldwide have written down around USD 1,400 billion. This blew big holes in their capital base, and in order to uphold confidence in the sector, governments rigged up extensive support programmes. Some USD 500 billion was pumped into the banks, while bank debts and asset risks were guaranteed and deposit guarantees were extended. Large amounts were required to stabilise institutions, relative to GDP especially in Ireland, Belgium and the UK.

Real economy hit hard

7. The current economic downturn is deeper, more prolonged and more widespread than those occurring after 15 previous crisis periods in history, according to a multi-country study by Reinhart and Reinhart (2010). This reflects the radical deleveraging in the financial system. The study shows that deleveraging after a financial crisis is often initially postponed and is a lengthy process of on average seven years. The revival following a financial crisis hence tends to be very slow. A rapid recovery in the global economy set in over a year ago. As of the end of last year, that recovery has gradually flattened out somewhat, but the likelihood of a double dip in the US seems slight.

The European debt crisis: imbalances underpin negative momentum

8. Let me mention some words on the debt crisis that is currently plaguing Europe, on the causes and on the policy response. It was clear when establishing EMU that the currency union did not satisfy the ideal conditions. A currency union should preferably be coupled with a political union, and the latter – notwithstanding the continuing European integration – is still not in place. Large balance-of-payments imbalances had been built up, with Germany and the Netherlands running surpluses of around 5% of GDP and the so called peripheral countries reporting deficits of 5% of GDP or more. The current account deficits were a signal of major structural imbalances, such as in public finances. When investors became reluctant to finance the deficits, the debt crisis unfolded. This threatened financial stability Europe-wide because the countries in the euro area are highly interdependent financially.

Decisive action by governments required

9. In the market turbulence last May, Greece was the epicentre. With drastic intervention, government leaders and the ECB temporarily managed to turn the tide and

market turmoil abated. However, owing to concerns surrounding Ireland, the market turbulence flared up again recent weeks, with market participants fearing potential contagion to other peripheral countries. To maintain market and public confidence, it is essential that countries make every effort to introduce a credible consolidation programme and reforms to bring public finances onto a sustainable path. The primary responsibility for improving public finances lies with the authorities. Moreover, Europe and the IMF have set up an ultimate safety net that could also be resorted to if need be, while the Eurosystem provides enhanced credit support with the aim of safeguarding monetary transmission and preventing tight credit rationing in the private sector. In November, Ireland concluded a program with the European Commission and the IMF, in liaison with the ECB. This program will deliver an important contribution to restoring financial stability in the country.

Lessons learned and challenges

10. The worldwide crisis has exposed some fundamentally weak spots in the international economy and the global financial system. In many cases the efforts to address them have only just got under way, while there is still much uncertainty about the effects of the measures. I will focus on two main challenges, first strengthening the banking sector and second enhancing macro-prudential oversight.

Strengthening the resilience of banks

11. Banks were at the epicentre of the crisis. After the wave of bank collapses, nationalisations, conversions, break-ups, sales, bailouts – all of which impacted on the real economy – the financial and banking system seems to have stabilised and to be on its way to recovery. However, reforms are essential to make the financial and the banking system truly resilient during periods of stress. The Basel Committee on Banking Supervision has announced a comprehensive package of measures to strengthening the banking sector. The contents of what we now call Basel III were endorsed by the G20 World leaders, in Seoul beginning of November. Basel III contains *bankspecific reforms*, the goal of which is to make banks more resilient to shocks. It also addresses *system wide risks,* as a bank-specific approach will not be enough.

Bank specific reforms

12. The core of the bank-specific reforms is stronger capital and liquidity regulation. Raising the *quality* of the capital base has been one of the primary objectives of Basel III. In the future, the emphasis will be on *core* capital, that is common equity and retained earnings, and banks will have less incentive to attract lower quality capital. In line with these qualitative improvements is the increase in the *minimum quantity* of regulatory capital. For the first time, a hard minimum requirement has been set for core capital, namely 4.5% of a bank's total risk-weighted assets. In addition, the Committee has improved *risk coverage* of the regulatory framework and more improvements are on the way. The goal is to ensure that all material risks are captured. During the crisis, many risks were not reflected in the risk-based regime. Capital requirements for trading book exposures as well as for complex securitisations and exposures to off-balance-sheet vehicles will be increased substantially, about three to four times the old capital requirements.

13. An additional element to the capital framework is a *leverage ratio*, which will serve as a backstop to the risk-based capital requirement. In the lead-up to the crisis, many banks reported very strong risk-based capital ratios while, at the same time, managed to build up high levels of on- and off-balance sheet leverage. The use of a supplementary leverage ratio will help contain the build-up of excessive leverage. It will also serve as an additional safeguard against attempts to "game" the risk-based requirements and it will help address model risk. A minimum leverage ratio of 3% will be tested during an observation period.

14. The proposed *liquidity* framework will also have a profound effect since a global liquidity standard does not currently exist. During the crisis, funding remained in short supply for an extended period. In response, the Committee has proposed global minimum liquidity standards to make banks more resilient to potential short-term disruptions in access to funding and to address longer-term structural liquidity mismatches in their balance sheets. The Liquidity Coverage Ratio will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario. This is complemented by the Net Stable Funding Ratio, which is a longer-term structural ratio designed to address liquidity mismatches.

Addressing system-wide risks

15. However, this firm-specific approach by itself will not be sufficient. Broader macroprudential measures to strengthen the entire banking system are equally important. An essential element in addressing system wide risk is the build up of buffers in good times that can be drawn down in periods of stress. The Committee has introduced two capital buffers. First a *capital conservation buffer*, which will increase the minimum capital requirements with 2.5%. As bank's capital levels move closer to minimum requirements, the conservation buffer will impose a constraint on its discretionary distributions, like dividend payments, share buybacks and bonuses. Secondly, the *countercyclical buffer*, which would be imposed when excess credit growth is associated with an excessive build-up of system-wide risk. This buffer can vary between 0 and 2.5%.

16. In order to give banks time to adjust to the new requirements and to support the ongoing economic recovery, Basel III will be implemented gradually. From 2013 onwards, the increase of the minimum requirement for core capital will be phased in three years' time. And only thereafter the capital conservation buffer will be introduced step-by-step in four years' time. The new liquidity standards will be implemented after an observation period to ensure their effectiveness.

Too important to fail

17. But an effective system wide focuses also addresses problems related to interconnectedness and the perception that some banks are too important to fail. Some institutions have grown so vital for financial stability that they have become systemically important and their failure is not a socially acceptable option. During the financial crisis, government authorities had no other choice then to save these institutions. At the same time losses of external capital providers were kept to a minimum. Let me explain the concept of systemically important financial institutions, the so called SIFIs, and discuss the international policy response to address the problems related to "too important to fail".

18. There are roughly three characteristics that make an institution systemically important: its size, interconnectedness and limited substitutability. Size measures the volume of financial services provided by a financial institution. Interconnectedness increases the extent to which problems at an institution may affect the financial system. This may happen via an institution's direct links with other institutions as well as indirectly, via its role in the financial infrastructure or financial markets. The third factor, limited substitutability, indicates that if crucial functions or services cannot be quickly and easily taken over by another party, the system can become seriously disrupted.

19. Aside from these structural characteristics of institutions, two other factors may accelerate the spillover to the entire financial system. First of all, the complexity of the organisation structure. Complex and internationally active banks cannot be easily wound up nor can their crucial functions be easily transferred to another party. Secondly, in a crisis situation, confidence effects and herding behaviour of market participants play a reinforcing role.

FSB Framework for SIFIs

These contagion channels made bailouts of systemic institutions during the crisis inevitable. Such intervention, however, carries a number of problems, like a burden on fiscal position, creating moral hazard by making government guarantees explicit, and undermining the level playing-field between institutions. Therefore, steps have been taken to tackle the *too-important-to-fail* problem. The Financial Stability Board has developed a policy framework to deal with systemically important financial institutions, which the G20 World leaders ratified last month. This framework is designed to reduce the ***probability*** and ***impact*** of a failure of a SIFI. It rests on more intensive supervision, higher buffers for SIFIs compared to Basel III and an increased resolution capacity of national authorities.

The case for macro-prudential oversight

20. On top of these new standards and regulations, enhancing ***supervision*** is also vital. Macro-prudential oversight is, to put it simply, the missing link between the different approaches of a central bank and a financial supervisor. A central bank significantly promotes financial stability by aiming at low inflation, sound payment systems and sustainable credit growth. Supervisors exercise their responsibility for the stability of individual financial institutions by ensuring that they have adequate buffers to withstand shocks. The problem is that both responsibilities, although closely interrelated, have been poorly attuned. Let me explain.

21. In the run-up to the crisis, most central banks warned against the risks to the financial system. But these warnings did not prove meaningful, as they were not effectively translated into mitigating action by supervisors. Likewise, most supervisors believed that if individual institutions were sound, the financial system as a whole would be too. However, the financial crisis has shown that supervision of individual institutions is important, but not sufficient to preserve financial stability.

22. The message is clear: the supervision of the financial system as a whole should be strengthened to lower the chance and impact of future crises, and this requires central banks and supervisors to join forces. One important added value of macro-prudential oversight is that it looks at the interactions between financial institutions and their environment. A single bank, say, can exercise only a limited influence on housing prices. But, if many banks eased their credit standards for mortgage loans, housing prices could soar, possibly causing the housing market to overheat. A housing market crash can entail huge losses for the banking sector and the real economy. Thus, by monitoring the interactions within the financial system, including the dynamics behind a build-up of imbalances, macro-prudential oversight can identify threats to financial stability. In light of these lessons, the EU political authorities have decided to establish a new European Systemic Risk Board per 1 January 2011 to strengthen macro-prudential oversight in the EU.

Conclusion

23. Ladies and gentlemen, let me come to an end. I have talked about one of the most sweeping crises the financial world has been confronted with since a long time. Governments, supervisors and the financial sector worldwide have replied to this with ambitious measures and reforms. I am sure that many people, maybe even some among you, will question whether all these measures and initiatives will in the end improve the world? It is a simple and fair question, with no easy answer! And though I am no fortune teller, I firmly believe that these reforms will make the financial sector healthier, stabilise economies and so improve the world.

24. And the need for these reforms is evident. A recent IMF study, for instance, estimates the costs of a financial crisis at around 15 percent of GDP, while research that

factors in the long-term impact of a crisis might easily arrive at a multiple of this figure. With the measures we discussed, future crises will become less probable. At the same time we should realise that this objective is not presented to us on a silver platter. All the parties involved will have to work hard to meet all the requirements now that implementation is the next challenge. So let us not wait too long, and start making plans instead.

Thank you for your attention.