# Andreas Dombret: Reform of the global financial system

Opening lecture by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Generation Forum, Eltville, 16 June 2011.

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## 1. Introduction

Ladies and gentlemen,

The reform of the global financial system will be in the limelight during the next two days of lectures and debates. I was asked to kick off the discussion by presenting you, in brief, the Bundesbank's point of view about the ongoing regulatory reform process. What has already been achieved, and what key issues still need to be tackled?

## 2. Regulatory reform – what has been achieved?

The global financial crisis has been keeping us extremely busy for some 4 years now. Looking back, there is little doubt that an inadequate regulatory framework was one of the most important causes of this crisis. Thus, it is imperative to learn the right lessons and minimise the likelihood of future crises by closing the regulatory loopholes and mending the weaknesses that have come to the surface.

Significant progress has already been made in this regard. Therefore, I will restrict myself to mentioning only two key measures.

Firstly, the new capital and liquidity standards for the banking sector, commonly known as Basel III, were finally endorsed by the G20 at their meeting last November in Seoul. Capital requirements will rise considerably in terms of both quantity and quality. Moreover, the first-time introduction of global liquidity standards will bolster banks' liquidity cushions, thereby addressing the possibility of contagion via the money markets and excessive maturity transformation. All in all, the new rules will significantly strengthen the resilience of financial institutions.

Secondly, and related to Basel III, substantial progress has also been made in tackling the problem of how to deal with systemically important financial institutions, called SIFIs for short. As you all know, the striking feature of SIFIs is that their insolvency is regarded as virtually intolerable – because they are particularly large, complex or interconnected. Or because they perform specific functions that cannot be readily assumed by other market participants.

Back at the Seoul Summit last year, the G20 accepted a comprehensive framework on how to address the SIFI problem put forward to them by the Financial Stability Board. Work on specifying the framework's individual recommendations is currently being pursued as a matter of urgency. The final framework will be spelled out in detail by the next G20 Summit, which will take place in Cannes in November of this year.

## 3. What remains to be done?

Notwithstanding the progress already made, there is still a long way to go in making the international financial system watertight. In my following remarks, I would like to point out three aspects of regulatory reform that will accompany us in the coming months.

Firstly, it is indispensable to finalise, and then implement without delay, the FSB framework for dealing with SIFIs. Secondly, we have to introduce internationally compatible restructuring and resolution regimes for financial institutions to allow them to exit the market in an orderly fashion without causing a breakdown of the system. And finally, we must identify the so-called shadow banking system and expose it to supervision.

Let me now briefly discuss these three areas in more detail.

### *3.1 Dealing with SIFIs*

As already mentioned, the FSB is currently finalising its recommendations for dealing with SIFIs. One difficulty here lies in accurately identifying SIFIs based on criteria such as size, interconnectedness, substitutability and complexity. I would like to promote a rather pragmatic approach towards solving this problem: We should start with only those institutions that are indisputably of global systemic relevance. I expect this to be a group of some 25 to 30 banks – not more and not less. The composition of this group will surely change over time.

As experience is gained, we might later extend the framework in an appropriate manner to other SIFIs, including financial institutions of domestic relevance, financial market infrastructures, insurance companies and other non-bank financial institutions.

Central to the FSB concept are systemic capital surcharges for SIFIs that go well beyond the requirements mandatory under Basel III. Such capital add-ons do more than merely improve the resilience of a SIFI, in other words reduce its probability of failure. They surely are also a suitable instrument with which to put a price tag on the implicit guarantee that SIFIs are deemed to enjoy. Formal decisions have yet to be taken as to the exact application modalities of the SIFI surcharge, especially its size. Nevertheless, I expect that at the end of the day the amount of additional capital required from a SIFI will be related to its systemic importance and will in all likelihood lie somewhere between two and three percent.

What is also still being discussed is the choice of capital instruments acceptable for the surcharge. Common equity surely appears to be the natural choice for the additional charge. But I think other instruments with full loss absorbing capacity deserve careful consideration. For instance, contingent capital – in other words debt that converts into equity once certain stress triggers are hit – affords loss absorbency when needed.

We have to bear in mind that contingent capital is still largely uncharted territory. It might be necessary to conduct further research and gather practical experience with these untried and untested instruments, especially the market implications of contingent capital and the associated net financial stability implications. Nevertheless, contingent capital, when properly designed, is likely to represent a major step forward in providing additional loss absorbency. Let’s all realise that contingent capital was part of the Basel III communiqué.[1] Therefore, the Bundesbank continues to be in favour of including contingent capital in the SIFI package.

### *3.2 Introducing restructuring and resolution regimes*

Closely related to SIFIs is my second issue, namely the need for appropriate restructuring and resolution regimes for the financial sector. Let’s all realise that we will never fully prevent individual institutions from going bankrupt. Failure is part and parcel of a market economy. But if financial institutions fail they must not be allowed to drag down the entire system with them. Unfortunately, in many countries general insolvency laws have proven inadequate during the crisis. Hence there is clearly a need for special mechanisms that allow for an orderly restructuring and resolution of financial institutions. A strong resolution regime makes failure a credible option and thus reduces moral hazard.

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[1] See also Basel Committee on Banking Supervision, Group of Governors and Heads of Supervision announces higher global minimum capital standards, 12 September 2010.

In this regard, significant progress has already been made on a national level. For instance, in Germany the so-called Restructuring Act came into effect at the beginning of this year. Its elements include a significant extension of supervisory powers, especially the possibility of transferring financial assets of a distressed bank to a private bank or to a public bridge bank. Remaining parts can then be wound up during insolvency proceedings, if necessary. To reduce the financial burden of the public sector in future crises, the Act provides for a restructuring fund that is to be financed through a levy from the banking sector.

Despite all its positive features the German Restructuring Act represents largely uncharted legal territory and has certain limits once banks with significant cross border business are involved. This is another reason why we need internationally harmonised resolution mechanisms.

While progress on a national level has been remarkable in many countries, obstacles to effective cross-border resolution remain. Thus, one of our main tasks in the coming months will be to establish and ensure mutual compatibility between different national restructuring and resolution mechanisms. Yet we should bear in mind that an orderly resolution of financial institutions which are truly active on a global level may be possible only to a certain degree. At the European level at least, the proposed European Commission legislation, which is due before this summer, looks to represent a major step forward.

### *3.3 Let's not overlook the shadow banking system*

The third regulatory challenge I want to address is the necessity to extend our reform efforts beyond the banking system.

The stricter rules imposed on banks via Basel III and the rules for SIFIs entail the realistic danger that activities will be shifted to less regulated areas. Therefore, it is imperative for us to better illuminate the fringes of the financial system. In other words, we must closely monitor and regulate what is commonly referred to as the shadow banking system.

Whether a market participant is classified as belonging to the shadow banking system should depend not so much on its institutional type but on its activities. At the behest of the G20, the FSB is currently exploring ways and means of monitoring and regulating the shadow banking system. It has recently defined the term shadow banking as "*credit intermediation involving entities and activities outside the regular banking system*".[2] This rather broad definition involves non-banks such as special purpose vehicles and money market funds, but also hedge funds.

The FSB will present a set of recommendations to the G20 in autumn of this year. What is already obvious today is the need to significantly enhance transparency by imposing appropriate registration requirements as well as reporting obligations on all parts of the financial system.

Yet better monitoring will not be enough. To reduce systemic risk, better regulation of the shadow banking system will be necessary too. This could be done either directly, by regulating the activities and actors of the shadow banking system themselves. Or indirectly, by regulating banks' interactions with the shadow banking system.

## 4 Need for international cooperation

Let me close by emphasising once more the urgent need for international cooperation. More than 4 years after the outbreak of the crisis, we are now at a crossroads. Our cooperation in

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2 See FSB, Shadow Banking: Scoping the Issues, A Background Note of the Financial Stability Board, 12 April 2011.

the coming months will decide whether the new rules for the financial system will be internationally compatible or bring about an uneven level playing field, leading to regulatory arbitrage.

At the end of the day, it is the globally consistent implementation and transposition of the adopted key reforms into national law that counts. While heterogeneous national structures make it imperative to maintain a certain degree of flexibility when reforming financial regulation, we must ensure that individual countries do not game the system to the benefit of their own financial institutions.

Financial centres, when vying for a good position among themselves, must under no circumstances be permitted to engage in activities at the expense of financial stability, not least given the ever closer interconnectedness in the global financial system. Individual countries should not seek advantages by watering down, or by reluctantly implementing internationally agreed reforms. To avoid such beggar-thy-neighbour policies, transparency, peer pressure and a close monitoring of progress in implementing agreed standards and measures will be essential.

## 5. Conclusion

Ladies and gentlemen,

To sum up:

A number of crucial reform measures designed to secure financial stability have already been approved or are under way. Yet important tasks still lie ahead. Above all, we need

- to find a solution for the SIFI problem;
- to ensure that all financial institutions can be resolved without dragging down the whole system; and
- to identify the shadow banking system and expose it to supervision.

In doing all this, we must strike the right balance between paying sufficient attention to peculiarities of national financial systems and ensuring an international level playing field.

Thank you for your attention!