Nout Wellink: Looking beyond the current reforms

Speech by Mr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Amsterdam Financial Forum, Amsterdam, 17 June 2011.

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The history of The Grand dates back to 1578, even before the establishment of the Amsterdam Stock Exchange, which is the oldest in the world. In the course of the centuries, the buildings of The Grand underwent quite a few architectural changes and additions. As a consequence, they have not become outdated, and today they provide a great location for the Amsterdam Financial Forum. It is easy to see a parallel between the architecture of this site and the future global financial architecture, the topic of this session. We need to keep financial system regulation up to date as well and make quite a few changes and additions to it in the course of time.

My term as governor is coming to an end. In about two weeks time, I will hand over the presidency of the Dutch Central Bank to my successor, Klaas Knot. In these last days, I am not going to look back on the past 14 years. Neither will I focus on what is going on in the financial system today. Instead, I will share some thoughts with you about the future of the financial system. That future is being shaped by a broad set of new regulations addressing weaknesses exposed by the financial crisis. In this speech, I will briefly highlight the main elements of these reforms. After that, I will focus on the consequences for the financial system – both the intended and the unintended ones. Looking beyond the current reforms, I also have a few messages for regulators and for the financial sector.

Key elements of the current reforms

The financial system is currently being reformed. Some new rules are already fully in effect, others are being phased in or are still being fleshed out. For some issues, the approach differs per country. Nonetheless, several key common elements can be identified. I will discuss the following four: capital requirements, liquidity requirements, measures to reduce excessive risk taking, and resolution measures.

Capital requirements are a first key element. During the crisis, it turned out that banks had insufficient buffers to withstand large losses. The Basel III framework therefore sets tighter capital standards. Most importantly, it requires that the quality of bank capital be improved. A larger part of capital must consist of common equity, the most loss absorbing type.

Furthermore, banks will have to increase the size of their capital buffer. The new regulations involve a higher minimum capital ratio as well as heavier risk weights for specific activities. For proprietary trading, which caused large losses during the crisis, and investments in re-securitisations, a complex and relatively high-risk financial instrument, banks will have to hold much larger capital buffers. Still, in good times, risks may again be underestimated. Therefore the new regulations also set a limit for leverage regardless of risk weights.

To further ensure the build-up of additional buffers in good times and enhance the capacity of banks to absorb losses in bad times, the Basel III framework introduces dynamic capital requirements. These come on top of the minimum capital requirements that must be met at all times and by all banks. The dynamic buffer consists of two parts. One part, the capital conservation buffer, relates the build-up of buffers to the profits of an individual bank. The other part, the countercyclical buffer, relates it to conditions in the economy at large. This is truly a novelty: for the first time in history, a macroprudential element has been included in international banking regulations.

On top of the minimum and dynamic requirements, there will be a capital surcharge for systemically important banks. This will make those banks whose failure would pose the greatest threat to the financial system yet a little bit safer.

The second key element of the current reforms concerns liquidity requirements. These are essential to make the financial system more stable. Liquidity and maturity transformation is at the core of the banking business and provides a large benefit to the economy. It enables households and companies to earn interest on savings that they can access at any time, while providing essential long-term financing to the economy. However, when excessive, maturity transformation creates a vulnerability to market shocks and can become a source of instability to the financial system. During the crisis, insufficient management of liquidity risk emerged as a major problem. Even well-capitalised financial institutions experienced liquidity problems and central banks needed to intervene, including with unconventional measures, to provide large scale financing and thereby prevent further escalation.

Therefore the new liquidity requirements, introduced as part of the Basel III framework, are of utmost importance. They require banks to hold sufficient high quality liquid assets to cover net cash outflows for a period of 30 days under a stress scenario. In addition, they set minimum requirements for the use of long-term and stable funding sources to finance long-term lending. Together, these measures will help to prevent excessive maturity transformation. Given the importance of these liquidity requirements, it is worrying that the EU has not yet shown a clear commitment to implement them in full, without any reservations.

Next to capital and liquidity requirements, there is a variety of other measures aimed at reducing excessive risk taking. These are a third element of the current reforms. For instance, in the US, the Volcker rule may impose direct restrictions on trading by banks for their own account. For banks based in Europe, excessive risk taking will be discouraged by remuneration rules. These rules require that traders with a significant risk-taking role will receive part of their bonus in the form of shares with a delay of several years. Thus, if high-risk trading results in large losses, then traders will share in these losses.

The fourth key element of the current reforms consists of resolution measures. The crisis has shown that with the current regulatory tools large banks cannot be allowed to fail, because the costs for society would be too large. However, a bank failure can never be fully prevented – not even with the new rules for capital and liquidity and the other measures. It is therefore essential that any bank failure can be resolved at minimal cost and, if possible, without taxpayer support.

Resolution measures include the preparation of recovery and resolution plans, or living wills. These plans provide detailed guidance for emergency measures and, if these were to fail, an orderly restructuring or bankruptcy. In addition, in some countries there is a discussion about precautionary measures such as ring-fencing of retail activities.

Regardless of the precise regulatory approach, to make the failure of a large international bank – however unlikely it may be – a manageable event, some banks may need to change their structure. Unfortunately, for the near future, resolution frameworks will remain focussed on the national level, because an international resolution regime is not politically feasible. As a consequence, resolution can be inhibited by the complex structure of large banks, many of which consist of thousands of legal entities all over the world that are interconnected through a variety of financial arrangements. To be able to quickly restructure a bank in times of crisis, these interdependencies must be made transparent and reduced.

Consequences for the financial system

The current reforms will undoubtedly increase the resilience of financial institutions and enhance the stability of the system as a whole. However, there will also be broader consequences for the financial system. Some of those consequences are intended, others

are unintended. Looking beyond the current reforms, which will take years to be fully implemented, I will now say something about the outcomes. What follows refers to the financial system as a whole, not to specific countries or institutions.

First, besides reducing risks, the reforms will inevitably lead to unintended risk shifting. The new regulations will increase resilience and discourage excessive risk taking in of most parts of the financial sector, but elsewhere financial risks are likely to grow larger.

For instance, risks will shift to households. There is already an ongoing trend of insurers providing less guarantees on new life insurance policies. This is largely driven by the lessons that institutional investors learned from previous crises, but they may well be reinforced by new regulations, such as Solvency 2. As a consequence, households are bearing more and more financial market risks, even though they may not be very well equipped to deal with those risks. That is an unintended consequence.

Like before the crisis, risks may also shift to unregulated entities that form a shadow banking system. Maturity and liquidity transformation do not only take place within the official banking system, but also outside it. To some extent, this is being addressed in the current reforms. However, some part of financial innovation will always be aimed at circumventing existing regulations. An unintended but likely outcome is therefore that over time, risks will again shift to yet unregulated areas. The response should not be to control innovation, but to closely monitor the main vulnerabilities in the financial system and adapt the regulatory framework when necessary.

A second consequence for the financial system is that the reforms will induce changes to business models. For banks and insurers, some activities and investments will become less attractive due to the current reforms. Banks may move out of certain trades for their own account, for instance, because the required capital buffers will reduce the return on equity. Under Solvency 2, insurers may find it unattractive to continue investing in complex structured products, because of the high risk weight and the detailed analysis that is required of the underlying assets. Furthermore, retail deposits will become a favoured source of bank funding, as a consequence of the new liquidity requirements. These are just some examples.

Such changes in business models are not merely side effects; they are a necessary outcome of the current reforms. Changes in business models are a fully intended consequence. If there would be no significant changes to business models, and if that would mean that risk profiles remained too high and potential threats to the stability of the financial system were insufficiently addressed, then we will need to see a further tightening of the rules.

The most profound changes to business models will probably not result from capital or liquidity requirements or from other measures to reduce excessive risk taking. Instead, the most profound impact will come from resolution measures. That is because effective resolution measures will put an end to the "too big to fail" or "too big to save" status of systemically important financial institutions. When they loose this status, large financial institutions will also loose important competitive advantages over smaller and less interconnected institutions.

At present, systemically important banks enjoy an implicit subsidy on their funding costs. This is apparent in credit ratings, for instance. Credit rating agencies assign higher ratings to large banks than their intrinsic financial strength would justify. The rating enhancement reflects the probability of government support and can be as large as five notches. For smaller banks, the enhancement is lower or even zero, because it is perceived that smaller banks are less likely to receive government support when they get in trouble. Effective resolution measures will thus eliminate the support-related rating advantage and lower funding costs of large banks. A capital surcharge for systemically important banks fits with this reasoning and compensates for the unfair benefits of being very large. This is a fully intended consequence and will enhance economic efficiency and market discipline.

But there may be unintended consequences too. Ideally, governments would agree an international resolution framework, but that requires international burden sharing in case they would have to support the restructuring of a cross-border bank. At present, this is not a realistic option. The alternative, national resolution regimes, imply that some degree of autonomy for domestic retail operations may be a necessary precondition for effective resolution. This comes at a cost. Financial integration can make financial markets more efficient, especially within a common market like the EU. It enables banks to raise funds where they are readily available and invest those funds where they generate the largest return, even if that is in another country. In addition, banks can diversify their risks by combining retail and investment banking. If the economic benefits from international and universal banking operations cannot be fully realised, that would be an unintended and indeed an undesirable outcome.

A third consequence of the current reforms is that they will have an impact on financial markets. We know for sure that there will be an impact and we can almost be sure about the direction of some changes. For instance, banks will need to attract more stable long-term funding. At the same time, European insurers, which are important providers of bank funding, show an increasing preference for investment in covered bonds because of the low capital requirements under Solvency 2. Together with a range of other factors, this will give a boost to European covered bond markets.

However, we cannot be sure how large and how permanent the changes will be. That is because there are many different factors at work. Some market participants, such as pension funds and other large investors, are much less affected by the current reforms. They will respond to changes in market prices and this may partly offset the impact of new regulations. This makes the overall impact on financial markets uncertain.

It is therefore important that major new regulations are phased in gradually. The new liquidity measures for banks provide an example of this approach. They are phased in over four to seven years to prevent large shocks to financial markets. In addition, they are subject to an observation period to facilitate mitigation of undesirable outcomes.

A fourth consequence from the current reforms is that the financial system will continue to suffer from important distortions. In other words, there will be incentives for financial institutions to behave in a way that is not in the public interest. Of course, this will always be the case. The perfect world of economists, without distortions or frictions of any kind, exists only in their models. Still, it is worth pointing out a few important distortions that the current reforms have been unable to tackle.

Perhaps the most important distortion is that high leverage will remain attractive for financial corporations because interest payments are tax deductible. This makes it attractive for a company to use more debt financing and less equity capital than would be desirable from a social point of view. Of course, this distortion exists for non-financial corporations as well. Yet in the financial sector it is more troublesome, because tax considerations do not just have an effect on the funding choices, they also stimulate the design of tax-driven financial products. Such products may add little economic value, but create leverage and complexity, increasing vulnerabilities in the financial system and making them more difficult to monitor.

Another distortion is that the current reforms are not uniform across countries. For example, countries with a large financial sector, such as Switzerland, will require large banks to hold more capital than the international standard. Furthermore, EU remuneration rules will apply to the global operations of banks headquartered in Europe and the US Volcker rule will apply to the global operations of banks headquartered in the US. The lack of uniformity has the unintended consequence that banks operating abroad in the same market, but headquartered in different countries, will each have to observe different rules. This causes unfair competition, induces arbitrage and creates complexity. However, just as with resolution frameworks, it is a political reality that some reforms, however desirable they may be, can only be passed at the national level.

Concluding remarks

Looking beyond the current reforms, there will be major changes to the financial system, some intended and others unintended. Regulators will have to monitor the consequences carefully and respond to what they see. Risks will shift away from where they are regulated most tightly. Regulators will also need to evaluate the impact on financial markets and the effects of market distortions. If they detect the emergence of new vulnerabilities, rules will need to be adjusted. Furthermore, business models have to be adapted. If the largest banks do not undergo a substantial transformation, a further tightening of banking regulations will be required to produce the intended outcome.

One thing is certain: beyond the current reforms, further reforms will be necessary to safeguard the stability of the financial system. It took ten years to develop the Basel II framework. The current, more profound reforms will have taken shape in about half that period. Future regulators should continue this trend and make sure that regulation of the financial system keeps evolving, especially when public concerns about global financial crises fade away. And ideally, the next round of reforms should be even more harmonised at the international level, to reduce unfair competition and unproductive barriers to financial integration.

I also have two messages for the financial sector. First, within the new regulatory framework, it is important that financial institutions continue to strengthen their own risk assessments. To all executives that are present here, I would say: you have a responsibility of your own as well.

Second, risk shifting and financial innovation imply that the regulatory framework will continue to evolve and will never be completed. Therefore your business models should be sufficiently flexible and not fine-tuned to a current set of regulations. You have seen that most of today's regulators are quick and determined to pass the necessary reforms. I am confident that this will also apply to tomorrow's regulators, who will continue to make changes and additions to the future global financial architecture.