Jürgen Stark: Towards a safer financial system

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the Transatlantic Business Conference, organised by the American Chamber of Commerce, Frankfurt am Main, 9 November 2011.

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Ladies and Gentlemen,

It is a pleasure for me to speak to you tonight at the Transatlantic Business Conference.

1. Looking back to 2008/09

It is exactly three years ago that the G20 Finance Ministers and Governors met for the first time after the Lehman default. In Sao Paulo, on 9th of November 2008, the Group of Twenty recognized that "*the global economy is facing its most serious financial crisis and economic slowdown in decades*".[1] In that meeting, they also pointed to the root causes that have led to the crisis: "[…] *the current financial crisis is largely a result of excessive risk taking and faulty risk management practices in financial markets, inconsistent macroeconomic policies, which gave rise to domestic and external imbalances, as well as deficiencies in financial regulation and supervision in some advanced countries*." The G20 members drew the conclusion that "*all countries […] must improve their regulatory and supervisory regimes.*"

Let me in my remarks tonight discuss where we stand with this G20 process and assess, particularly, what has been achieved regarding the financial market regulations agenda. My focus will be on the Basel III framework and the priorities for the future. I will then broaden my perspective and turn to the question on the role of finance for economic growth more generally.

So let me briefly discuss how we reached the point where we stand. Following the November 2008 meeting in Sao Paulo, the G20 meetings in Washington in the same month, in London in spring 2009 and finally in Pittsburgh in autumn 2009 led to an agenda for putting financial regulation on better footing. Already the declaration of the Washington Summit established the major principles that should henceforth guide the reform of financial markets:

first, strengthening transparency and accountability;

second, enhancing sound regulation;

third, promoting integrity in financial markets;

fourth, reinforcing international cooperation;

fifth, reforming international financial institutions.

As for the call for better regulation, the declaration pledged "*to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances*."

The G20 Leaders' Statement of Pittsburgh in 2009 foresaw "*strict and precise timetables*" for the implementation of the reforms. However, after the initial impetus following the impression of the climax of the financial crisis, the steps to reform have been frequently criticized to have lost momentum. In fact, the Financial Stability Board has put in place a framework to monitor the progress on implementing the G20 financial reforms. This shows that for some of the

[1] See http://www.g20.org/index.aspx for the G20 statements.

identified priority areas, achievements have not reached beyond a settlement of general agreements, but significant progress has been made.

Important reforms are expected to be finalized only in the years to come. This is true. for instance for the important field of regulating and supervising the shadow banking system, in which only next year work will begin on setting the details of the respective policies. Also the necessary regulations or legislation to implement the Basel III framework – especially the strengthening of banks' capital and liquidity standards – will start to be put in place as of January 2013. The full set of regulations will only be phased in by 2019, more than ten years after the recent financial crisis had seen its peak.

The G20 leaders at the 2009 Pittsburgh meeting have warned that "*a sense of normalcy should not lead to complacency*". Indeed, the first signs of a re-stabilizing global economy has withdrawn the necessary push behind the process of reforming financial regulation. While regulators have correctly adopted the view that it is more important to make regulations right and waterproof, we have to ensure that the financial sector reform is put in place in a thorough but also swift manner.

2. Reforming financial system regulations: a snapshot of the current state

Let me turn to outlining the current state of the financial sector reform and focus in particular on the new international agreement on capital and liquidity standards – known as Basel III framework. This framework mainly contains five central elements:

The first is the strengthening of the quality and quantity of bank capital, and a harmonisation of the calculation of regulatory capital across jurisdictions. Better and higher bank capital is needed in order to foster the loss-absorbing capacity of banks. To this aim, Basel III increased the minimum common equity Tier 1 (CET1) ratio from 2% to 4.5% of risk weighted assets.

The second is the requirement for banks to build-up buffers above the required minimum, particularly when the economy is booming, thereby providing for additional cushions to absorb losses in periods of financial distress.[2] In addition, further buffer requirements are foreseen for systemically important financial institutions (SIFIs) as well.

The third element is directed to enhance the "risk coverage" of the regulatory framework, providing a more comprehensive treatment of banks' exposures to complex financial products whose risk to the system has been neglected so far.

The fourth element is the adoption of a simple and transparent rule to prevent the excessive reliance on debt by the banking sector.

And last, but not least, the new framework intends to improve banks' resilience to liquidity shocks and to increase market confidence in the liquidity position of banks. The intended improvements in the liquidity position of banks aim at containing the excessive reliance on short-term funding and give incentives to hold safe and liquid assets.

Once the new regulatory framework will be fully implemented in Europe and worldwide, the scope and magnitude of changes in regulatory requirements will yield – in my view – several long-term benefits.

First, the implementation of harmonised, world-wide rules on capital requirements will level the playing field for banks with international reach, boosting competition and increasing the availability of financial services to both households and non-financial corporations.

[2] The capital conservation buffer will equal 2.5% of risk weighted assets, setting the target CET1 ratio (together with the 4.5% minimum requirement) at 7%. The counter-cyclical capital buffer will vary between 0% and 2.5% of risk weighted assets.

Second, cyclical buffers will help to protect the banking sector and the real economy from the system-wide risks associated with the boom-bust cycle in aggregate credit growth.

And third, the new liquidity requirements will ensure that the banking sector has enough high-quality liquid assets to withstand acute funding stress, as well as guarantee that longer-term assets are funded by more stable medium or longer-term sources.

Perhaps the most important benefits of a safer financial system are those stemming from an effective prevention and mitigation of banking crisis that are associated with substantial economic and social costs. Indeed, as history shows, systemic banking crises can produce losses that are multiples of annual GDP, which undoubtedly makes the benefits of reducing the likelihood of costly financial crisis very high.

The costs of the recent crisis were in fact sizeable. For the year 2009, a GDP loss of about 4 percent was recorded for the OECD countries. There is possibly also a permanent depressing effect on medium-term potential output.[3]

Governments and central banks took unprecedented action globally in response to the perils originating from the financial market turmoil. Euro area governments, for instance, increased their deficits on average by more than 5 percentage points of GDP in 2010. This was a joint consequence of rescue packages for financial institutions, cyclical stimulus packages and operations of automatic stabilizers. In 2010, Ireland recorded a deficit of over 30 percent, resulting from a one-off support for its banking sector. Debt-to-GDP ratios in advanced economies have increased on average by about 25 percentage points since 2007.

Central banks around the world expanded their balance sheets, though to different extents and with different asset-liability structures.

It is clear that in our democracies, such measures taken by fiscal and monetary authorities can only be an exception. They are not at all repeatable, neither in nature nor in scale. The disasters that we witnessed in the financial system must not repeat themselves. It all leads to one conclusion: Reforms are urgent!

The Basel III framework means some progress on the way towards a more sound and resilient financial system and in my view it is at the core of financial regulation.

Nonetheless, to complete the G20 Action Plan, further policy actions need to be taken. Let me just highlight three initiatives that I consider as key elements of the new regulatory framework:

(i) the regulation of credit rating agencies,

(ii) the regulation of the shadow banking system, including hedge funds, and

(iii) the establishment of effective bank resolution regimes.

Concerning credit rating agencies, the FSB published in October 2010 a set of principles that aim at reducing reliance on external credit ratings. International standard setters and national authorities now have to translate these principles into specific policy actions. However, the work in this field remains at an early stage, and the progress has to be accelerated significantly in several jurisdictions.

But let me also mention that important steps have already been taken in this field. For example, the Dodd-Frank Act in the US requires authorities to remove all references to or requirements for credit ratings from regulations. An important challenge for authorities, however, is to develop alternative standards that could reliably indicate the creditworthiness of borrowers.

[3] See OECD (2010), "Economic Policy Reforms – Going for Growth", Part 1.

Concerning the regulation of the shadow banking sector, it is important to close the gaps between strengthened banking regulation and the non-regulated entities. Work is currently underway at the FSB level to define the perimeter of the "shadow banking system"[4] and to analyse its role in financial intermediation and in risk transfer to the wider financial system. Detailed recommendations on the regulatory treatment of shadow banking are expected to be prepared only by 2012. In the EU, work on shadow banking, however is at a relatively early stage, currently focussing on a stocktaking of existing regulations and conducting a data sharing exercise.

Finally, let me also mention that the development of effective bank resolution regimes, which has been on the top of the global and EU regulatory agendas, is also a key element of a successful policy response to the recent crisis. There is now a broad consensus that all distressed institutions, particularly systemic ones, should be dealt with by authorities in a way which safeguards the stability of the financial system as a whole and minimises public costs and economic disruption.

In the US several banks were allowed to fail in an orderly manner in the recent years, which could provide an example for other countries as well concerning the set-up of an efficient resolution regime in a national context. However, it has to be acknowledged that most of these banks in the US were rather small compared to average European bank sizes and they were almost exclusively national based with no or very little cross-border operation.

Therefore, substantial challenges remain for authorities around the globe to establish effective cross-border resolutions schemes, in particular for global systematically important banks. The new frameworks should be guided by the FSB's new international standard for resolution regimes, as endorsed by G20 Leaders at their Cannes Summit of 4 November 2011.[5] This standard could mean a substantial improvement, since it not only contains a broad arsenal of effective resolution tools, but also provisions to facilitate cooperation among national authorities. Nonetheless, in my view, a greater centralization of crisis management and resolution responsibilities for cross-border SIFIs would also be needed, with a strong coordinating role for the home authority. In this regard, I would very much welcome a move towards an EU-level resolution authority, the same way as our supervisory system moved already partly from national to the EU level.

3. A bird's eye view: the size and role of the financial sector

With this quick résumé of where we stand in overhauling financial regulation in mind, let me turn to the more general question what role the financial sector is playing in our economies at large.

A major German newspaper recently published a poll that had asked respondents to name those five professions for which they have the highest respect.[6] The results of the survey found the respect for "Bankers and bank employees" ranking at the bottom. Even the profession of "Politicians" was considered more – albeit marginally – respectable. Only "TV moderators" fared inferiorly to bankers.

Such a derogatory view of the financial industry is not a new phenomenon, though. Churchill apparently uttered in 1925 that he "*would rather see finance less proud and industry more content*."

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[4] Currently no exact definition of the "shadow banking system" exists. According to the FSB, it can broadly be described as "credit intermediation involving entities and activities outside the regular banking system" (See Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board, 27 October 2011).

[5] Financial Stability Board: Key Attributes of Effective Resolution Regimes, 4 November 2011.

[6] See Frankfurter Allgemeine Sonntagszeitung, 30 October 2011.

The negative perception of the financial industry often focuses on compensation practices. In fact, commentators have frequently expressed their scepticism on whether the activities of bankers and market players deserve those high wages and bonuses compared to the economic rewards earned in other industries. Already Keynes wondered "… *how long will it be necessary to pay City men so entirely out of proportion to what other servants of society commonly receive for performing social services not less useful or difficult*?"

It is by now well understood that excessive wage and bonus packages in some segments of financial markets have encouraged irresponsible risk-taking. Thus, incentives were set inappropriately. Against this backdrop, it comes as no surprise that the overhaul of compensation practices in the financial sector appears to have dragged the most broad-based public attention among all the components of the financial sector reforms.

Let me remark en passant that for improving financial institutions' own corporate governance as well as its public acceptance it will be key that compensation schemes will set incentives to take into account the long term viability and success of such institutions. This includes internalising the repercussions of the risks involved, and not just the maximization of the short term profit objectives.

While the growth of wages and compensation in the financial sector is striking, it is not the only dimension at which the financial industry is being criticized to have "outgrown".

Let me illustrate this with some key figures. A telling measure of the size of the financial sector is given by the share of stocks, bonds and loans to the private sector as a percentage of GDP. With the exception of Japan, this measure has also trended upwards in major OECD economies. This measure of the size of the financial sector stood around 430% of GDP in the United Kingdom, 315% in the United States, and 262% in the euro area, averaged over the period 2005 to 2009.[7]

Finally, the so-called shadow banking system has been likewise growing rapidly before the crisis. Estimates of the assets in the shadow banking system, based on a proxy measure for non-bank credit intermediation for Australia, Canada, Japan, Korea, the United Kingdom, the United States and the euro area, saw a rise from $27 trillion in 2002 to $60 trillion in 2007. Following a slight subsequent decline, that number stood again at a similar magnitude in 2010.[8]

The two or three decades before the crisis have seen a strong increase of the financial sector in advanced economies. Viewed together with the negative experiences of the recent financial crisis, it is thus tempting to assert that the financial sector has in fact grown out of proportion. In what follows, I will address this assessment in more detail.

The idea that "too much finance" can be detrimental for economic growth, has found some empirical and theoretical confirmation in the academic literature.[9] It evidences a non-monotonic relation between the size of the financial sector and average growth: if the size of the financial system exceeds a certain threshold, it may have a negative growth impact. One mechanism behind such pattern may be that a larger financial sector would contribute to exacerbating the positive relation between average growth and the probability of sizeable economic downturns. Another explanation would be that even in tranquil times, an oversized financial sector may represent a misallocation of financial and human resources that could be better utilized elsewhere in the economy.

Clearly, further research is needed in this respect. This regards in particular a characterization of the optimal size of the financial sector. Nevertheless, it should be already clear that it cannot be the sheer scale of activity in the financial sector *per se* that matters for growth and economic welfare, but rather the types and qualities of financial sector activity.

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7 The figures are based on calculations using data from WFE, IMF, Datastream and Eurostat.

8 Financial Stability Board (2011), "Shadow Banking: Strengthening Oversight and Regulation", October 2011.

9 See, e.g., Arcand, J.-L., Berkes, E. and Panizza, U. (2011), "Too much finance?", on www.voxeu.org.

This applies in particular to our assessment of the years before the crisis. Beyond merely stating – somewhat bluntly – that "the financial sector had become too big", I think that we can draw the more specific conclusion:

"The financial sector had stepped out of its role of serving the real economy."

Let me explain in more detail what I mean by this.

It has long been recognized that the financial sector does not exist in the economy "for its own sake", but its role is one of servicing the real economy. Or as Joseph Schumpeter put it in 1934: *"He (the banker) stands between those who wish to form new combinations and the possessors of productive means… He is the ephor (the overseer) of the exchange economy."*[10]

In fact, all the elements that have been identified in the finance and economics literature as the key functions of the financial sector are eventually directed towards the support of the real economy:

- providing information about investment projects and allocating capital;
- monitoring investments and exerting corporate governance after providing finance;
- facilitating trading, diversification and management of risk;
- and mobilizing and pooling savings.[11]

In providing these services, the financial industry plays its role to contribute to sustainable economic growth.

I would argue that, during the recent years, the financial sector has lost focus in playing this role. In a period characterized

- by search-for-yield with inadequate risk assessment and pricing,
- by weak underwriting standards,
- by inadequate risk management practices,
- by fragile short-term funding of long-term assets,
- by a proliferation of opaque financial products,
- and by excessive leverage,

the financial sector has become to some extent self-referential.

Rather than helping with a proper diversification and management of risk, the financial sector itself created a huge tail risk for the rest of the economy. As Raguram Rajan summarized in his book "Fault Lines": "*The financial sector is, in many ways, the brain of a modern economy. When it functions well, it allocates resources and risk effectively and thereby boosts economic growth. [...] It works for all of us. Of course, when it works poorly, as has done recently, it can do enormous damage while befitting a very few*."[12]

Part of the failures was certainly attributable to deficiencies in financial regulation and supervision. The regulatory overhaul of the financial sector is intending to correct this and thus help the financial sector to refocus on its servicing role.

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[10] See Schumpeter, J.A. (1934), "The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest and the Business Cycle", Harvard University Press.

[11] For this list of functions see Levine, R. (2005), "Finance and Growth: Theory, Evidence, and Mechanisms", in P. Aghion and S. Durlauf (eds), The Handbook of Economic Growth, North Holland.

[12] See Rajan, R.G. (2010), "Fault Lines", Princeton University Press.

- Strengthening of bank capital and liquidity standards,
- addressing systemically important financial institutions,
- improving over-the-counter derivatives markets and core financial market infrastructures,
- and a reform of compensation practices, that I mentioned before,
- these are all important elements in this process.

At the same time, regulatory reforms themselves require regular revaluation. As a case in point, the ongoing sovereign debt crisis has put into question the treatment of sovereign debt risk on banks' balance sheets. When the financial crisis started, few would have suspected how prevalent a risk some of these allegedly safe and liquid assets could become for banks. Now, however, it has to be seriously reflected whether debt should no longer be assigned a zero risk weight under the EU's Capital Requirements Directive and rather be subjected to a regulatory capital charge. Government bonds are not risk-free anymore.

Looking forward, a system that serves its role of serving the real economy requires a safer and more narrowly focused banking system, equipped with sufficiently high capital. Indeed, the fact that a sound and role-focused financial system has to be smaller than the status quo ante is apparently becoming recognized on a broad basis. Recently, Peter Fisher, senior managing director of Fixed Income Portfolio Management at BlackRock, was reported to have claimed "*I understand we want to make individual firms stronger but our banking system is too large*", and he asserted that the financial sector in Western Europe and North America has to shrink by 25%. I daresay that this is a rather unsuspicious voice supporting the call for a smaller, more stable and re-focused financial system.[13] Others go even further, arguing that the financial sector should shrink by one third.

4. Conclusion

Let me conclude. Recent years have seen a financial system that

- has outgrown in size,
- lost track of its core functions,
- and became a major source of risk itself.

Overall, the financial sector has veered from its genuine role of servicing the real economy.

The current process of overhauling financial system regulation are an important factor to help the financial sector become safer and thus eventually to contribute to sustainable economic growth.

It is now important not to lose momentum and to strictly follow the schedules for implementation. At the same time, the adequacy of the regulatory system needs to be assessed on a regular basis. This helps avoiding the mistake of the past that regulators fail to spot new sources of risk arising in the financial sector.

The guiding principle on all regulatory measures and any re-dimensioning of the financial sector must be: finance has to regain its core role of servicing the real economy without becoming a source of risk itself.

In this way we are heading towards a safer financial system for the benefit of all of us.

Thank you for your attention.

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[13] See http://www.marketwatch.com/story/blackrocks-fisher-banks-must-shrink-by-25-2011-09-23.