Andreas Dombret: International coordination to enforce regulatory reform

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Salzburg Global Seminar "Financial regulation – bridging global differences", Salzburg, 16 August 2012.

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1. Introduction

Ladies and gentlemen,

To cut to the chase: International collaboration between regulators has never been so challenging – and yet never has collaboration been so important.

Let me explain.

2. Financial sector reform – time to slow down?

The regulatory community is currently facing enormous pressures. The sovereign debt crisis has given a fresh impetus to calls to water down or delay regulatory reform. Some argue that the ongoing uncertainty in financial markets and the weak global economy are good reasons to ease up on regulatory pressure. They say the financial sector is being asked to do too much too soon, and regulators should slow the speed of adjustment.

Yet I see it as more a case of "too little, too late": If there is a reproach to be made, it is that regulatory progress has not been faster. The sovereign debt crisis, which is not least driven by systemic problems in some countries' banking systems, underscores the urgent need to make the financial system more resilient. Relying on financial markets' self-regulation will not do, I am afraid. We must deliver on our promise and extend regulation and oversight to all systemically important financial institutions, instruments and markets.

To deliver this promise, close international collaboration is essential. Given the truly global financial system, "going it alone" is no longer a viable option. It will only lead to the migration of business and to regulatory arbitrage, undermining not only the integrity, efficiency and orderly functioning of financial markets, but ultimately undermining financial stability.

3. International consistency versus one-size-fits-all

The crisis has clearly demonstrated that countries cannot successfully regulate their financial markets and firms in isolation. Capital flows do not stop at geographical borders; quite a number of financial institutions operate globally. Therefore, an internationally coordinated regulatory response is imperative. To be successful, reforms must be implemented at least at the major financial centres.

International cooperation is not an end in itself, however. Instead, I suggest to measure its value by the extent to which it provides financial stability. While adopting a robust, common set of rules is essential, it is neither practical nor desirable to fine-tune all details of financial regulation internationally. As the characteristics of each country's financial system differ, sometimes significantly, I do not think it to be appropriate to apply completely identical rules to every country or region. We must strike the right balance between providing a workable level playing field and at the same time providing sufficient flexibility for the peculiarities of national financial systems. The leitmotif for financial regulation ought to be *international consistency,* not *one-size-fits-all.*

A uniform set of rules and regulations would deprive us of the benefits of international regulatory competition. By this, I do not mean competition where countries are undercutting each other with ever laxer, but also ever more risky regulation. This would be equivalent to a

race to the bottom as we would invite market players to arbitrage across divergent national regimes.

By regulatory competition, I mean assessing the merits of regulatory approaches and measures undertaken by other countries and, if deemed appropriate, adopting these approaches and measures. In short – learning from one another. For instance, in the USA, the Federal Deposit Insurance Corporation, FDIC for short, has gained an extensive wealth of experience in resolving failing financial institutions. In my opinion it would be careless for European authorities not to draw on the knowledge of their US colleagues when implementing their own resolution regimes.

4. Need for international cooperation

The work to develop a new regulatory framework for the international financial system is slowly but surely nearing completion. An example of what has been achieved through intensive cooperation is the new regulatory standard for bank capital and liquidity, commonly known as "Basel III", or the comprehensive policy framework for dealing with systemically important financial institutions, SIFIs for short.

Yet, we can not at all be satisfied with what has been achieved. While rule-making at the global level is a *necessary condition* for financial stability, it is by no means a *sufficient condition*. Rather, for the agreed reforms to be effective, they have to be translated into national laws and regulations. This must be done in a globally consistent manner and according to agreed timelines. Here, we must significantly step up our efforts and cooperate as closely as possible. Otherwise, we risk failing.

Let me illustrate this with three examples.

4.1 Solving the too-big-to-fail problem

Solving the too-big-to-fail problem will, without a doubt, constitute the litmus test of financial sector reform. The aim is clear: Taxpayers should not again be stuck with the tab for financial institutions' failures. To achieve this, we must return to a founding principle of social market economy: individual responsibility. Those who take risks must also face the consequences. The possibility of losses and even default is a constitutive element of any functioning market – and financial markets can not and must not be an exception to this.

Therefore, we have to find ways of resolving financial institutions, however large, complex, interconnected or internationally active, without causing systemic disruptions. Obviously this demands international cooperation. National resolution regimes are stretched to their limits when it comes to globally operating SIFIs. To borrow the well-known line from Mervyn King, the Governor of the Bank of England: "*Global banking institutions are global in life but national in death*". In the past, if internationally active banks ran into trouble, national supervisors regularly ring-fenced their assets. Banking groups were broken up or rescued as separate entities along national boundaries. This led to systemic distortions and considerable costs to taxpayers.

Against this background, the Financial Stability Board has developed, and the G20 have adopted, a new international standard for resolution regimes, known as the *Key Attributes of Effective Resolution Regimes for Financial Institutions*.

I very much welcome this development. The Key Attributes represent a major step forward, for the first time stipulating at the global level main features that national resolution regimes should include. Yet, following their adoption by the G20, the Key Attributes must now be implemented consistently across borders. Here, a great deal of work remains to be done. The Key Attributes have to be transposed into legislation which, naturally, has to be much more concrete than the international standard.

The necessity of close cooperation is further underscored by the fact that the European Commission has recently published its legislative proposal for an EU framework for bank recovery and resolution. It is of utmost importance to ensure consistency between the two frameworks. Otherwise we risk unnecessary inconsistencies and, consequently, new problems in the event of financial institutions becoming distressed.

4.2 Monitoring and regulating the shadow banking system

The so-called shadow banking system can serve as another prime example for the need for close cooperation. Firstly, there is the immediate threat of regulatory arbitrage, as stricter rules imposed on banks via Basel III as well as the rules for SIFIs set incentives for activities and risks to be pushed from the core of the financial system outward to the periphery.

Secondly, the fluid, evolutionary nature of the shadow banking system is a reminder to us not to focus solely on risks which have come to light during the current crisis. We have to be flexible enough to capture future developments as well. To ensure this, exchanging information across jurisdictions on a regular basis is crucial.

Regarding *better monitoring*, a lot has already been achieved. The FSB set out recommendations which now have to be implemented by national authorities. Additionally, the FSB has committed to conduct annual global monitoring exercises to assess global trends and risks in the shadow banking system.

Regarding *better regulation*, work at the international level is ongoing to examine potential gaps and inconsistencies of the existing framework. Several working groups are currently developing proposals on possible regulatory measures. An integrated set of policy recommendations will be presented by the end of this year. These recommendations will then have to be implemented at national level, calling, once again, for close international cooperation to ensure consistency.

4.3 Enhancing compensation practices

Reforming compensation practices in the financial sector shall serve as my final example. Asymmetries in remuneration systems in terms of risk and reward led to short-termism and excessive risk-taking. They also contributed to the large, in some cases extreme absolute levels of compensation, leaving firms with less capacity to absorb losses as risks materialised.

Good work should be rewarded with good money. Yet to be good, work has to be sustainable and responsible. To safeguard financial stability, remuneration systems in the financial sector must be better aligned to long-term value creation as well as prudent risk-taking, including through malus or clawback arrangements. The *Principles for Sound Compensation Practices* and their *Implementation Standards* developed by the FSB are both helpful and welcomed guidelines to this effect.

To address the concerns of firms and improve cross-border supervisory cooperation, the FSB established its *Bilateral Complaint Handling Process* in early 2012. This mechanism enables national supervisors to bilaterally report, verify and, if necessary, address specific compensation-related complaints by financial institutions that derive from level playing field concerns.

Yet, it will take a lot of stamina and endurance to achieve lasting change in behaviour and culture within the financial sector. The organised manipulation of LIBOR is just one cautionary example for this. While progress has been made in implementing the FSB Principles and Standards, more work is necessary to ensure a level playing field in the market for highly skilled employees. Sustained commitment and close cooperation of supervisory authorities therefore remain essential.

5. Intensified implementation monitoring

The success of financial sector reform crucially depends on the timely and globally consistent implementation of agreed policies. As major reforms to address risks and strengthen regulation across the financial system have been adopted, it is becoming increasingly important to ensure that countries live up to their commitments. By means of peer pressure and transparency, we have to make sure that the measures necessary to improve the stability of the financial system are actually put into practice.

A number of steps to ensure effective and timely implementation of internationally agreed reforms have already been taken. The results of numerous monitoring exercises are summarised by the FSB in regular scoreboards and public progress reports to the G20. In order to enhance the effectiveness of implementation monitoring, the FSB and important standard setting bodies have jointly established a *Coordination Framework for Implementation Monitoring*. In addition, the FSB monitors the implementation and effectiveness of international financial standards and policies via its peer review programme. Peer reviews are an important tool to promote consistency, enabling FSB members to engage in dialogue with peers and share lessons and experiences. It is necessary to continue on this path.

6. Closing remarks

Allow me to summarise:

Firstly, ongoing stress in the financial system and a weak economic recovery in many countries is no excuse to weaken our commitment to financial sector reform.

Secondly, today's interconnected financial markets cannot effectively be regulated nationally. Close international cooperation is warranted.

Thirdly, we must strike the right balance between achieving a level playing field and providing sufficient flexibility for the peculiarities of national financial systems.

Finally, rigorous implementation monitoring will be indispensable. As the old saying goes: Trust, but verify.