Mugur Isărescu: The future of the international banking system

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I. Introduction

I was asked to address this Conference about the future of the international banking system. It is not an easy task at all, at least for two reasons.

The first reason is that I am addressing a Conference of the Club of Rome, a forum for open debates and for launching mainly revolutionary ideas. I am afraid that my position, as the Governor of the National Bank of Romania, does not allow me to have more than an evolutionary vision on the banking system. I know that from time to time, and mostly during crisis periods, banks and financial markets are considered the root of all evil. I have to accept that markets in general, especially financial markets, do not function perfectly, but I will paraphrase Winston Churchill and say that the market mechanism could be bad, but better than any other economic and financial mechanisms that humanity has known until now. You have in front of you a person who lived forty years in a centrally planned economy. Consequently, I am afraid that my paper about improvements of the mechanisms of the financial and banking markets might turn out rather boring and conservative as I will only talk about some improvements, not about radical changes. But as we, bankers, have to put up with the stress test, I ask of you to be resilient during my presentation.

The second reason is because peering into the future is based on our capacity to assess risks. We do this by using our inbred capacity to weigh probabilities, which is, in our modern times, supported by mathematical models. Nevertheless, our capacity to assess what lies ahead is impaired when facing uncertainty, as it was the case since the outbreak of the current crisis.

However, we are fortunate. As Alan Greenspan noted, "there is a degree of historical continuity in the way democratic societies and market economies function." This means that there is a "persistent stability" that can be used for inferring what the future might look like. All we have to do is learning the lessons of the past.

II. Historical overview

Looking carefully at the economic history, we see two sorts of changes. Some legal and economic institutions change slowly enough to allow us to anticipate future outcomes fairly accurately. But from time to time, there are some very rapid or significant legal or institutional changes. Such events usually emerge in the aftermath of a deep crisis. This seems to be the case these days. New legal provisions and new institutions are needed to build the banking union or the fiscal union.

For more than two decades I have been one of those who promoted democracy and market economy in Romania. Therefore I have to believe that Western civilization will continue to be democratic, applying the rule of law in market economies. With these institutions in place, we can look backwards to draw some lessons on the future of the banking sector. I will do this through the eyes of a central banker. A central banker is always interested in the way the banking system works. If the banking system moves away from being sound and shock-resilient, monetary policy becomes inefficient. When many changes are to be implemented, the risk of making mistakes cannot be ruled out.

One way to look at the banking system is to see its history as a succession of financial crises. In a nutshell, from the Great Depression to this day, the banking system faced two major financial crises: the one in the `30s and the current one. In between, there were some more or less mild financial crises. From this perspective, as a central banker, I see two trends. First, some financial crises, whether major or not, have led to in-depth reassessments of the regulation paradigm over time. Second, a cross-border approach to regulation policies has been developed gradually. However, it has recently accelerated as a prerequisite for the envisaged banking union.

II.1. The experience until the '60s

One of the main conclusions reached in the aftermath of the Great Depression was that competition in the banking sector could jeopardise financial stability. By putting downward pressures on profit margins, competition stimulates banks to take on new risks, thus reducing capital buffers.

Consequently, for the following four decades, until the late '60s, many measures were aimed at controlling competition. Particularly, limits were imposed on lending and deposit rates, on loans to the private sector, on main monetary variables (which are nowadays set by credit institutions). Likewise, worldwide restrictions were in place on cross-border capital flows and foreign exchange markets.

Note also that back in those days commercial banking was separated from investment banking (Glass-Steagall Act) and there was no financial innovation. In addition, policy rates were set by governments. Commercial bankers were paid well (but not remarkably well compared to other professionals) and the 3:6:3 rule accurately described their daily routine: borrow at 3%, lend at 6% and be on the golf course at 3 p.m.

In such a "risk-free" environment, capital requirements began to be eased, reaching 5% of bank assets. Extended liability was replaced by limited liability. During 1945–1971 no major banking crisis occurred (Eichengreen and Bordo, 2003), but this came at the cost of lower profitability of banks, whose capacity to innovate and support the economy went down.

But, as Andrew Crockett (2011) put it, facilitating informed risk-taking, the financial system is a key element in achieving optimal levels of productivity growth and rising living standards. Confronted with against-efficiency regulations, financial markets started to seek ways out. This is a lesson we should keep in mind.

II.2. The '70s and beyond

These ways out primarily took the form of the emergence of competitors to the US dollar as a settlement currency, the collapse of the Bretton Woods system and the establishment of international syndicate banks which began in 1964. Under the pressure of market forces, starting in the `80s, financial sector deregulation gained ground by loosening up legal and administrative restrictions. Almost all restrictions imposed up to the '60s were removed. A new era dawned, with markets enjoying more freedom.

One important result worth mentioning is that lending was no longer constrained by the volume of deposits or holdings of liquid assets. Banks could borrow on the interbank market at any time. Under the new circumstances, capital became the only factor containing the size of banks' books (Goodhart, 2010).

Setting appropriate requirements for bank capital was challenging to regulators and it remained so. On the one hand, a strong capital base is associated with the soundness of a bank. On the other hand, that comes at a price in terms of profitability. Capital adequacy requirements were unified under the Basel I Accord, which set them at 8% and established risk coefficients. But they were quickly watered down by the Basel II Accord, which allowed banks to assess their own risks, through sophisticated models.

Starting with the ‘80s, credit expansion was relatively rapid. Independent central banks appeared to have tamed inflation once and for all. New sophisticated financial instruments seemingly succeeded in reducing risks to low levels for ever. A new generation of investors emerged and took on risks that they could not afford. Cross-border transactions increased rapidly at unprecedented levels. After a period of several good years, euphoria emerged at the beginning of the 21st century.

The focus on return on equity (short-term) rather than on return on assets (long-term) provided wrong incentives for the owners and the managers of banks. Whereas in 1998 the detaining period for shares in a bank was three years on average in the US and in the UK, it decreased to 3 months in 2008, signalling the so-called “casino capitalism”. At the same time, while in 1989 the executive directors of the top seven US banks gained 100 times the average income of a median household, by 2007, they earned 500 times that income.

This disregard for risk sparked worries among the national and international authorities concerning potential threats to macroeconomic and financial stability. The interest in macroprudential policies, which nowadays are seen as vital, became manifest early in the `80s. However, policy implementation remained feeble and the unthinkable happened.

Now the most important mission is to correctly identify what went wrong and what principles we should use when making enhancements to our financial system. Before moving on to the next section which addresses these issues, let me draw two lessons.

First, overregulation is not good. As proved by the experience gathered from the `30s to the `60s, it can provide financial stability at the expense of future productivity and living standards. To quote Andrew Crockett again, “We should be careful that greater safety in banking is not purchased at the cost of reduced efficiency or additional risks elsewhere in the system”.

Second, proper functioning of markets requires adequate rules. To me, it seems that something was wrong not only with markets themselves, but with the way they were regulated. Regulation did not pay enough attention to problems that may appear when markets operate. Andrew Crocket explained that the “market mechanism failed because of perverse incentive, asymmetric information and conflict of interests”. This means that, as Tommaso Padoa-Schioppa described it a few years ago, this crisis is not only a failure of markets, but also a failure of governments and regulators.

In my view, free markets work properly given a set of good rules. It is natural for human beings to make free choices. It is the regulators` duty to design rules that always preserve this freedom while preventing, for as long as possible, the accumulation of problems from asymmetric information, perverse incentive and conflict of interests. The two approaches of regulation – the one up to the `60s and the one before the outbreak of the current crisis – are a proper basis for understanding what good rules might mean.

III. The financial system in the aftermath of the crisis

The financial industry is supposed to be the lubricant of the economic engine and ensure its smooth and efficient functioning. To grasp the sheer scale of its task, just imagine the billions of savers and investors whose interests have to be matched by the financial system, each of them having a particular behaviour, often driven by emotions. In doing so, financial institutions use specialized resources to assess and manage risks, including complicated mathematical models. Just think of the many Nobel prizes that were awarded for achievements in this field.

The complexity of financial intermediation explains some of the seemingly peculiar features of the financial system as, for instance, the fact that the volume of transactions on the forex market is many times larger than what would be required by the actual exchange of merchandise.

The major positive contribution of the financial system is its ability to deal with asymmetric information problems. Adverse selection and moral hazard are issues emerging from asymmetric information. They are a cost to society, as they hamper lending. Financial system expansion has been the natural solution of the society in order to overcome asymmetric information problems. Financial institutions put their capital at risk and derive income from the spread between lending and deposit rates. In doing so, they use specialized resources to assess credit risk and discipline the borrower.

The fact that it has failed, triggering heavy costs to the society, leads to deep public anger and resentment.

"While anger and resentment may be useful spurs to action" – to quote Andrew Crockett (2011) yet again – "they are much less helpful in shaping a balanced response to the crisis that both safeguards society against financial fragility and preserves the contribution that the financial sector makes to high quality sustainable growth". Indeed, the crisis response so far has perhaps focused too much on preventing future financial crises and neglected the fact that robust economic growth is simply not possible without the contribution of the financial system.

III.1. Why did the markets not deliver?

Nowadays the financial sector tends to be associated with its negative externalities, while ignoring the essential function it performs in the economy. These negative externalities refer to both the direct cost of bailing out financial institutions and the indirect cost of the ensuing economic recession. Overemphasizing negative externalities may lead however to regulations that excessively limit risk-taking, which is unavoidable if the financial sector is to stimulate private saving, enhance allocative efficiency and help smooth out economic fluctuations due to non-financial causes.

In theory, in the banking sector, stakeholders' interest should ensure that credit standards, risk management and controls, and capital cushion remain adequate, as fund providers would penalize managers who run excessive risks. In securities markets, long-term reputational concerns should have overcome incentives to exploit short-term information asymmetries.

Obviously, in practice, proper market functioning was distorted by perverse incentives and information asymmetry. A special role was played by implicit guarantees that regulators gave to market participants. These guarantees combined with the risk discounting usually associated with a prolonged bonanza and resulted in excessive risk-taking and leverage. In my view, the lesson is as follows: any good fix of the financial system should deal with the sources of market failure and not only try to prevent inconvenient outcomes.

In doing so, I think it is better to avoid over-complex regulation, which may indeed be self-defeating in the long run. There has been a tendency to over-regulate in the aftermath of the crisis: as Haldane and Madouros (2012) observed, whereas the first Basel accord had only 30 pages, attempts to make it more flexible and fashionable turned it into a 347 pages document in its second iteration, on which the ink had barely dried when the financial crisis hit, and attempts to plug the gaping holes it revealed pushed the page count to no less than 616 pages in the case of the Basel III agreement. In the US, whereas the original Glass-Steagall act, perhaps the most influential piece of legislation of the 20th century, had a mere 37 pages, the new Dodd-Frank Act of 2010 has 848 pages, and that's only the primary legislation – counting in the 400 pieces of detailed rule-making from various US regulatory agencies that are required for its implementation, the document risks topping 30,000 pages. The situation is similar in substance in Europe, where new regulatory directives and regulations account so far for 2,000 pages of primary legislation, and where detailed rule-making occur on a similar scale as in the US, we would end up with 60,000 pages for a now literal regulatory blanket. Today's financial markets are very complex and are becoming even more so. Haldane and Madouros are right: "as you do not fight fire with fire, so you

don't fight complexity with complexity". An efficient regulatory response should be grounded in simplicity. The "keep it simple" principle has never sounded truer.

III.2. Fixing the financial system

Attempts to fix the financial system seek to alter its structure by dealing with the scope, the size and the cross-border dimension of the financial activity. As concerns the scope, the basic idea is that financial institutions should be prohibited from undertaking certain potentially risky activities. Some proposals recommend reintroducing the separation between commercial and investment banking (as in the original Glass-Steagall Act). Others, such as the so-called "Volcker rule", distinguish between client-service trading and proprietary trading, basically banning the latter. Criticism of these proposals is three-fold: (i) the separation between commercial and investment banking is much more suitable to remove a conflict of interests rather than reduce credit risk; (ii) the major risk for commercial banking is, after all, credit risk; and (iii) in practice, it is difficult to delineate between proprietary trading and trading to hedge risk.

Regarding the size of financial institutions, let me go directly to the "too big to fail" institutions. Their contribution to systemic risk is more than proportional to their size. It is not possible for such institutions to be sold, merged or closed down without jeopardizing the economy as a whole. Standard bankruptcy legislation, providing protection from creditors, simply does not work. Given the systemic importance of such institutions, access to creditors is essential. A special resolution framework should be designed in such a way that market participants be confident that it can be activated without generating unacceptable risks for the economy.

Finally, the cross-border aspect of financial activity poses some particular challenges arising from the fact that legislation and bankruptcy regimes differ across countries. Moreover, national regulators have, above all, the responsibility to ensure financial stability in their own country. The correct answer here lies with oversight mechanisms being adapted in order to be able to deal with the challenges of globalization, rather than attempting to restrict the functioning of the financial system in order to reflect the limitations in international cooperation.

IV. The foreseeable future of the European banking systems: the banking union

Let me quote Tommaso Padoa-Schioppa once more. He wrote that the old way of thinking along the Westphalian concept of nation-states is no longer suited for policy action when dealing with problems that are transnational, such as the financial crisis. For instance, Europe as a whole does not have large external deficits, or a high indebtedness of the household sector. Yet, it is being penalized by markets because its politicians try to solve the problems along the lines of nation-states.

IV.1. The need for a banking union

From this perspective, the EMU is visibly incomplete. On the one hand, in the absence of a fiscal union, sovereign spreads vary according to market perception. On the other hand, in the absence of a banking union, banks are perceived as contingent liabilities of individual sovereigns.

The EU is presently dealing with the negative feedback loop between banks and sovereigns. The imperative need to break this vicious circle gave birth to a wide consensus that the banking union is a less controversial and more feasible solution than a fiscal union. It is viewed as a way to place the banking sector on a more sound footing and restore confidence in the euro. It is also viewed as a step towards a fiscal union.

A banking union is also a good answer from the perspective of the so-called "impossible trinity", which points out that financial stability and financial integration are not compatible with preserving supervision at national level (Schoenmaker, 2011).

IV.2. The project

Now let us turn to what the projected banking union would imply. The current design envisages the banking union as functional for the euro area with an opt-in clause applicable to non-euro area Member States. At this stage, the proposal consists of four complementary pillars.

First, there should be a single rulebook. This means that the members of the banking union should establish and implement a harmonized framework for banking regulation and supervision.

Second, there should be a single supra-national supervisory authority in charge across the union (the main supervisory tasks will be transferred from the national to the European level).

Third, there should be a single bank resolution mechanism to address potential banking crises.

Fourth and finally, there should be a single deposit guarantee scheme in order to harmonise and centralise deposit insurance.

IV.3. Assessing the project

Obviously, each pillar has its own pros and cons. Let me mention the most important ones.

As concerns the single rulebook, the financial crisis highlighted the danger of divergent national rules. The current context justifies the adoption of a common legal framework for banking regulation. The European Banking Authority would play the central role in elaborating the rulebook. The result will be (i) less regulatory arbitrage; (ii) a reinforcement of the competitive neutrality principle: same business, same risk, same rules; and (iii) a higher level of transparency, contributing to a robust and uniform regulatory framework in the Single Market.

On the other hand, there are some risks: (i) implementing the same rulebook across over 8,000 banks in 17 or more countries may not prove flexible enough; (ii) the tougher regulations currently in place at national level might be undermined in those non-euro area Member States which decide not to join the banking union. Local subsidiaries may choose to bypass the more prohibitive banking legislation by turning into branches.

The single supervisory mechanism could be created through the transfer of prudential supervision attributes from national authorities to the ECB. In this context, a number of tasks such as consumer protection, fight against money laundering and supervision of banks based in non-EU countries remain at the national level.

Meanwhile, the ECB takes the actual responsibility for supervising the banking system, being in charge of licensing credit institutions, ensuring compliance with capital, leverage and liquidity requirements and also supervising financial conglomerates on a consolidated basis.

A gradual timetable was designed to smooth the transition to the new mechanism. Starting from 1 January 2013, the ECB may choose to take over the supervision of any credit institution in the banking union. A particular focus will be on the entities which have received or requested public funding.

By 1 January 2014, all other banks should be under central supervision, with an earlier cut-off date (1 July 2013) for banks of major systemic importance.

The successful implementation of the mechanism would hold considerable weight in restoring confidence and increasing transparency in banking supervision. However, a couple of downsides are worth mentioning: (i) voluntary participation of non-euro states in the banking union may result in the fragmentation of the EU single market into participating and non-participating countries, and (ii) there is still uncertainty regarding the role of these countries within the single supervisory institution.

The question arises whether the decision to entrust the ECB with a banking supervision mandate was the appropriate choice. In my opinion, it seems that is the case, although a number of opinions highlighting potential problems should not be ignored. In favour of the ECB are its strong expertise in the financial sector, as well as the synergy that exists between banking supervision, on the one hand, and the lender-of-last-resort function and payment system oversight, on the other hand.

As the third pillar of the banking union, the single bank resolution mechanism is deemed to ensure a centralised management of banking crises that provides options for dealing with bank failures in an orderly way, with minimal disruptions to the economy. The principles of the resolution should be set out in a single rulebook and they should address the issues of the cost of bank recovery, the fiscal backstop, and the moral hazard problem that may occur.

The cost of banks' recovery or resolution should be borne by shareholders and creditors. Nevertheless, in the case of systemic crises, an explicit fiscal backstop may be required, on the design of which a political consensus will be difficult to achieve.

Another challenge to establishing this mechanism relates to the heterogeneous resolution framework at the national level, which calls for significant changes in national insolvency, labour and tax laws. Additionally, if the European Stability Mechanism were enabled to recapitalise banks directly, negative consequences could occur in terms of moral hazard within the single market, as well as unfair competition between participating and non-participating banks in the banking union.

However, one should not overlook the fact that the single bank resolution mechanism has the advantage of increasing the speed and credibility in addressing banking crises (especially cross-border failures).

As regards the single deposit guarantee scheme, the underlying idea is that a larger pool of resources reinforces confidence in the banking system. A caveat is worth mentioning, however: in times of extreme financial stress, the size of potential liabilities may undermine the credibility of the mechanism.

Even if this pillar is less urgent than the others, steps in this direction have already been taken. Specifically, the coverage of the national deposit guarantee schemes has been harmonised at the level of EUR 100,000/depositor/institution and measures to simplify protected deposit repayments have been adopted in terms of faster payouts and improved financing.

This single protection scheme is designed to ensure an equal treatment of depositors across EU countries, in complementarity with the Single Supervisory Mechanism.

From the perspective of non-euro countries, there are some potential negative consequences stemming from the establishment of the banking union in the euro area, which need to be assessed.

First of all, the failure to join the banking union could lead to possible changes in the domestic banking structure. Parent banks may decide to turn their subsidiaries into branches. This would be reflected by (i) additional fragmentation of financial sectors across the region, (ii) low availability of information to host-country regulators and supervisors, and (iii) lower capacity at institution and group levels to respond to domestic and regional developments. Secondly, incentives for deleveraging may emerge in a non-euro country remaining outside the banking union, also for circumstantial reasons of the home-country banking groups.

All in all, the advantages of joining a banking union outweigh, in my opinion, the drawbacks. As a matter of fact, given the current stage of financial globalization, a similar approach would also be advisable worldwide. Of course, I am not suggesting establishing a global banking union. I only suggest increasing cross-border supervisory cooperation. This would

mean new mechanisms, new techniques for sharing information, as well as harmonised approaches when dealing with banks in distress.

V. By way of conclusion

By way of conclusion, I would say that we should adjust our ways of thinking and acting to the shifting economic and financial reality, rather than force the financial system to embrace a more or less fashionable theoretical approach. Not only the current crisis, but also the troubled history of the banking system reveals that the viable solution is to find a balanced approach between the roles markets and governments have to play in order to put the economy on a smooth growth path. In this context, the financial system reform measures should aim not only at avoiding the outbreak of a new crisis in the future, but also at ensuring that the new architecture of the financial system enhances its ability to support sound economic growth.

Thank you very much for your attention and, last but not least, for your patience. I also appreciate that you accepted that I slipped from the shoes of the President of the Romanian Association of the Club of Rome into the ones of the Governor of the National Bank of Romania.

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