Andreas Dombret: Can regulation contribute towards greater stability of the financial system?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the general conference to mark the 60th anniversary of the Österreichische Bankwissenschaftliche Gesellschaft, Vienna, 1 October 2012.

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Ladies and gentlemen,

"Can regulation contribute towards greater stability of the financial system?" My answer to this question is, "Yes, but…." Or to be more precise: "Yes, but only if we pay more attention to certain things in future."

What do I mean by that?

I would like to begin by emphasising the great achievements that we have reached so far. The international financial system is considerably more resistant today than it was just a few years ago. Many important regulatory measures were tackled under the G20 financial sector reform agenda. Many initiatives have been converted into legislation or have already entered into force; others will follow in the months ahead.

Now I come to the "but" I just mentioned. In order to make the financial system truly safer, I believe we must pay more attention to the following two aspects in the future than we did up to now. First, we must have a closer look at the consistency of the many different regulatory projects. Second, we need to intensify international cooperation. Let me speak briefly about these two aspects

1) Pay greater attention to the consistency of regulation

We are currently working on a number of topics to make the international financial system more stable. Of course, the progress made so far varies from one area to the next. At this point I would like to mention just three examples that keep us busy at the moment:

- The transposition of capital requirements laid down in Basel III into European law (CRD IV/CRR),
- The new solvency regime for the European insurance sector (Solvency II) and
- The EU European Market Infrastructure Regulation (EMIR).

This small selection is enough to demonstrate the wide range of reforms that have been launched – from banks to insurers to individual financial instruments. This is both right and necessary. However there is a danger that we may lose overview of the financial system as a whole by pushing ahead with sector-specific regulations largely independently of one another.

We need to be aware of this risk and focus our attention more on the systemic aspects of regulation. It is important to adopt such an approach in order, for example, to effectively combat regulatory arbitrage. This is true with regard to the relocation of business activities from one jurisdiction to another as well as to evasive actions in the form of switching from one sector of the financial system to another. For example there is the danger that activities may be relocated from the banking sector to the less strictly regulated shadow banking system because banking regulations due to Basel III and the regulations governing systemically important financial institutions have been intensified.

Besides potential regulatory arbitrage, we must also pay more heed to the interplay between individual regulatory initiatives. Where there is a lack of consistency there is a danger that different measures may create conflicting incentives or cause countervailing effects. One such example is the interplay between the CRD IV/CRR and Solvency II regimes. The former seeks, among other things, to place bank funding on a more stable, long-term basis. However, under Solvency II and certain circumstances the effect can be to benefit short-dated bonds. Since insurers are among the leading investors in bank bonds, this can have a direct impact on the refunding costs for banks.

2) Intensify international cooperation

Besides gearing regulation more closely to systemic aspects, we have to push for greater cross-border cooperation. This is a precondition for preventing competitive distortions as a result of international regulatory arbitrage or gaps in regulation. Solo attempts for single nations are non-viable options. I therefore strongly welcome the fact that the G20 has become established as the central forum for international cooperation, and that the Financial Stability Board (FSB) has assumed a pivotal role in the international debate on regulation.

But at the same time we must maintain a certain degree of national flexibility. National financial systems continue to differ, in some cases substantially. This being so, it would not be appropriate to strive for across-the-board uniformity for all regulatory requirements. We should not stop competing for optimal regulation. By that I don't mean countries undercutting each other with more and more lax provisions. The last few years have shown, where such a "race to the bottom" can lead us. What is important is that we exchange experiences, learn from the past and, if necessary, subscribe to the regulatory approaches and measures implemented by other countries.

To sum up, let me say this:

We are on the right track. The international financial system is already considerably more stable. But only by focusing on the system as a whole and by continuing to work closely together will we have lasting success.

Thank you!