Andreas Dombret: Restoring confidence in the financial system

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Generation Forum "Communication across generations – regaining trust in banking", Euro Finance Week, Frankfurt am Main, 21 November 2012.

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1. Introduction

Ladies and gentlemen

The financial system is more resistant today than it was a few years ago. The G20 have launched a wide range of reforms – from financial institutions to financial markets to financial instruments. Banks have substantially improved their resilience by increasing both their capital and liquidity. Work is under way to strengthen oversight and regulation of the shadow banking system. Derivative markets are being transformed to reduce systemic risks.

Yet the financial system is still not as safe as it should be. More steps are necessary. In my short remarks, I will point out three of these steps: first, ending too big to fail; second, paying greater attention to the consistency of regulation; and finally, reviving individual responsibility.

2. Ending too big to fail

Let me turn to the first of my theses.

Financial sector reform has focused on protecting the public from having to pay for the mistakes of financial institutions – and quite rightly so. Too often, we have answered the failure of financial institutions by bailing them out, using taxpayers' money.

Unfortunately, despite some progress, too big to fail is still with us. There is still the risk that financial institutions that are particular large, complex, interconnected or globally active are in a position to jeopardise the entire financial system.

2.1 Separating banking functions?

So what can be done to overcome too big to fail? Some believe that introducing a system of separated banking functions – in other words, divorcing deposit-taking and lending from proprietary trading and investment banking – is the way forward. YetI am questioning if such a system can truly fulfil all the hopes invested in it. Let me explain.

The main argument in favour of separating banking functions is to avoid contagion. Separating deposit-taking and lending from capital market transactions is said to prevent a crisis from spilling from one of the areas of business into the other. This would allow "good" banks to fulfil the important task of supplying the real economy with credit while being shielded from risks inherent in investment banking.

Banks, however, that engage in risky transactions unrelated to the real economy, would be excluded from deposit insurance schemes. If things went wrong, they would not be rescued at taxpayers' expense. Thus, the separation could protect depositors and, at the same time, would reduce moral hazard as it would become more difficult to finance risky areas of business through insured deposits.

In addition, the separation of business areas could simplify group structures, thereby counteracting incentive and information problems which increase disproportionately with the size of banks. This would make banks more transparent and easier to manage, benefiting supervisory boards and management as well as supervisory authorities.

However, separating banking functions will not prevent future banking crises. Remember that, during the financial crisis, governments had to save many specialised banks in order to prevent systemic disruptions. The Lehman bankruptcy caused precisely such contagion, but not because customer deposits were at risk. Rather, it had many connections to other financial institutions including, above all, many counterparties in derivative transactions. Essentially the same applied to AIG which was not even a bank at all, but an insurer.

Even if there were a clean organisational separation, the interconnectedness of the financial sector and the resulting systemic importance of individual institutions would not be entirely eliminated. Economic linkages would remain. Financial institutions are linked not only through direct business relationships, but also indirectly through payment and securities settlement systems.

It is also difficult to decide how and where to draw the line between “good” and “not so good”. The boundaries between customer business, hedging transactions, market making and proprietary trading are very much fluid. And problems in drawing clear boundaries generally result in loopholes and incentives for regulatory arbitrage. We should not neglect the danger of transactions and risks being shifted from the banking sector to areas which are less closely monitored and regulated, such as, for example, the transfer of proprietary trading to hedge funds.

All in all, I do not see a clear case for separating banking functions. In other words, I do not believe this to be the first-best solution.

2.2 Introducing credible resolution regimes

Given these difficulties, what else can be done to end too big to fail? For me, rather than intervening in financial institutions’ business structures, the preferable regulatory solution is the credible threat of an orderly market exit. And the decisive factor here, as always when it comes to money and finances, is credibility. Only the credible threat that even systemically important financial institutions may exit the market, and that this can be executed in an orderly fashion, will restore trust in the rules of the game.

Unfortunately, the crisis has revealed a significant lack of suitable instruments for effectively dealing with failing financial institutions. Existing insolvency laws have proven inadequate in many countries, especially when it comes to firms that operate on a global level. Thus, new resolution tools, and credible tools at that, are needed.

Some progress has already been achieved in this regard. A year ago, the G20 Leaders endorsed a new international standard: the Key Attributes of Effective Resolution Regimes for Financial Institutions. These Key Attributes set out for the first time essential features of national resolution regimes on a global level. For instance, in future every G20 country is to entrust restructuring and resolution functions to appointed authorities. So-called Crisis Management Groups are already in place for nearly every global systemically important financial institution. Recovery and resolution planning will become mandatory for both financial institutions and authorities. In addition, firm-specific, cross-border cooperation agreements are to be put in place, setting out roles and responsibilities of home and host authorities.

The Key Attributes represent quite a step forward. Implementing them will gradually align national resolution regimes, thus ensuring smooth interaction between the different frameworks. I am hopeful that this will significantly curtail financial institutions’ ability to blackmail the taxpayer. It is now up to governments to transpose the Key Attributes into national law and legislation. In Europe, the draft directive for the restructuring and resolution of credit institutions and securities firms, which was published in June by the EU Commission, is an important step in the right direction. It is necessary to continue on this path.

3. Paying greater attention to consistency

When setting the rules for the financial system, one main challenge is that regulation has been geared towards a sector-specific approach. This is reflected, for example, in the way regulatory standards and principles applying to the banking, insurance and securities sectors have developed largely independently of one another. However, this entails the danger of losing sight of the financial system as a whole.

We need to be aware of this risk and focus our attention more on the systemic aspects of regulation. One of the most important reasons for this is the prevention of regulatory arbitrage. This applies not just to the relocation of business activities from one jurisdiction to another, but also to shifts between different sectors of the financial system. For instance, as already mentioned, tightening banking regulations may well push activities towards the shadow banking system.

Besides regulatory arbitrage, we must also pay attention to the cumulative effects of, and 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 may even cause countervailing effects. This then may diminish, or even completely prevent, the desired effects of new rules. Take, for example, the interplay between the Capital Requirements Directive/Capital Requirements Regulation, which serve to implement the Basel III rules in Europe, and Solvency II: the former seeks, among other things, to place bank funding on a more stable, long-term basis. However, Solvency II may, under certain circumstances, benefit short-dated bonds, impacting insurers' asset allocation and thus banks' funding costs.

4. Implementing Basel III

Ensuring consistency clearly calls for intensive cross-border cooperation. This holds especially true as the reform process is shifting from policy development to implementation. Countries must live up to their commitments and ensure the timely and globally consistent implementation of agreed policies. This applies, above all, to Basel III, which is without doubt the central achievement of our reform efforts. Although it has become apparent that some countries are having difficulties sticking to the timetable, I urge all authorities involved to implement the framework as internationally agreed.

Recently, there has been a somewhat disconcerting discussion about the perceived shortcomings of Basel III. Some argue that it is not enough. Others argue that it is too complex. Yet, neither of these criticisms is convincing. First, one clear lesson from the crisis is that banks' risk absorbing capacity was way too low. Therefore, Basel III substantially raises capital requirements, reducing the probability of bank failures and the associated risks to financial stability and to taxpayers.

Second, while risk measurement will never be perfect, simplicity can sometimes come at a cost, too. Operating exclusively on a simple non-risk-based ratio may counteract one of the Basel framework's overarching principles: more risk-taking means higher capital requirements. Having said this, I fully agree to the leverage ratio's overall intention which is to deliver a simple, transparent and credible ratio, complementing the risk-based capital requirements – and not replacing them. It should just serve as a backstop.

There is no alternative to implementing Basel III on a global scale. In particular, I call on my colleagues in the US not to unexpectedly question the whole framework in the 11th hour – after taking part in its negotiation during the entire process. Nobody would understand why the largest financial market in the world suddenly were to go its own way on capital rules. Every country must absolutely avoid seeking advantages by watering down, or by reluctantly implementing agreed reforms. Such a policy would only lead to new tensions in the financial markets during a time of anyhow increased stress. We simply cannot afford going down this route.

5. Reviving individual responsibility

The crisis has opened our eyes to an undue reliance on the market that has sometimes prevailed. Confidence in the financial system will only return if we improve the rules of the game. Yet, regulation can and will never catch everything. It can only put in place a consistent and reliable framework in which financial transactions take place, and try to prevent market forces from getting out of control. This does not mean simply banning undesired activities and stopping market processes. Statism and dirigism are, by no means, the right path to take.

Market participants themselves must do their part to strengthen financial stability. This implies, above all, returning to a founding principle of social market economy: individual responsibility. Those who take risks must not only reap the benefits but also face the consequences. The possibility of loss and default is a constitutive element of any functioning market economy – and financial markets cannot, and must not, be an exception to this. That is why it is so important that all financial institutions are able to exit the market in case of insolvency without impairing financial stability. And without using taxpayers' money.

Reviving individual responsibility requires a change in behaviour and a change in culture within the financial sector. The manipulation of LIBOR is just one shocking example for this. Bad attitude cannot be fixed by a few new rules. Nevertheless, a lot has already been set in motion. Banks are now seeing themselves more as servants to the real economy. Many move away from unrestrained pre-crisis profit targets. They are reconsidering their business models as well, focusing on retail and corporate banking.

Remuneration practices in the financial sector are also slowly, but surely changing for the better. There is no disputing that mismanaged remuneration systems helped cause the crisis. Asymmetries in terms of risk and reward led to short-termism and excessive risk-taking. Remuneration needs to be aligned to prudent risk-taking and be based on sustainable creation of value, rather than on short-term earnings. Don't get me wrong: good work needs to be rewarded with good money. Yet to be good, work has to be sustainable and responsible.

6. Conclusion

Let me sum up:

First, ending too big to fail is not everything. But without ending too big to fail, all comes to nothing. Rather than intervening in financial institutions' business structures, I prefer credible resolution systems.

Second, while setting the rules of the game, we must take on a more systemic perspective, paying attention to regulatory arbitrage and the interplay between individual reforms. Countries need to implement agreed policies consistently and on schedule, including in particular Basel III.

Finally, we have to return to individual responsibility: those who take risks may well reap the benefits but must also face the consequences.

Thank you very much for your attention.