# Andreas Dombret: Regulatory agenda of the international financial system – a coherent strategy

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bankenkonferenz 2013, Austrian Working Group on Banking and Finance, Vienna, 11 February 2013.

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## 1. Welcome

Professor Lucius

Ladies and gentlemen

First of all, thank you very much for inviting me to speak to you today at the opening of the banking conference.

Even though today's discussion is focused on the banking sector, please allow me to take an overarching perspective in my speech by looking at the financial sector as a whole. This is because the close linkages in the financial system – both within sectors and across sectors and countries – make it necessary to take account of existing connections and cross-linkages in regulation, too. Otherwise, there is a risk of individual regulatory measures working in opposite directions or even cancelling each other out. Instead of a coherent strategy, we would then have a patchwork carpet.

## 2. The regulatory agenda for the international financial system

At their summit in Washington D.C., the Heads of State or of Government of the G20 opted for an all-embracing approach. They decided to subject all systemically important financial institutions, financial markets and financial instruments to appropriate regulation and monitoring. After all, the financial crisis had exposed shortcomings in the financial system as a whole as well as in its regulation. The aim of the regulatory agenda is therefore to eliminate these shortcomings and to make the financial system as a whole more resilient.

The plan of action adopted in Washington marks the hour that the regulatory agenda saw the light of day, so to speak. At the following G20 summits, this agenda was successively refined and worked through stage by stage. In this context, the international Financial Stability Board (FSB) plays a key coordinating role. This is because the regulatory agenda consists of several components on which the relevant standard-setting bodies and international committees are working in parallel. The reforms that are being tackled range from strengthening financial supervision through improved transparency regulations to measures designed to correct the false incentives stemming from systems of remuneration. Coordinating all these strands of work is the task of the FSB, which is also responsible for regular reporting to the G20.

The large number of work strands and regulatory provisions might create the impression that the sometimes exaggerated faith in the market prior to the crisis is now being replaced by excessive faith in government. Let me make it clear: what matters for us is not the sheer number of regulations but their quality.

After all, the purpose of regulations is to create a consistent and reliable regulatory framework that sets the right incentive for market players to behave in a risk-conscious manner. The regulatory reforms initiated by the G20 are therefore also aimed at reasserting market economy principles – such as the unity of liability and control in particular. Ultimately, functioning financial markets are indispensable for our general economic wellbeing, since they ensure the efficient allocation of risks and capital.

## 3. Cross-linkages and connections

The close interlinkages within the international financial system mean that sector-specific regulations can also impact on other sectors and market players. The individual elements of the regulatory agenda therefore not only have to build up stage by stage, one on top of the other; they also have to be interlocked.

For example, close links exist between the banking and insurance sectors, not least because insurers invest in bank bonds on a significant scale. Regulation of one sector therefore always has implications for the other. For that reason, any interactions between the solvency regime for insurers and bank regulation have to be borne in mind if we are pursuing a coherent regulatory agenda.

The regulatory framework for systemically important financial institutions, known as SIFIs, provides us with an example of the cross-sector applicability of regulatory provisions. This framework was developed under the aegis of the FSB and was adopted by the G20 in November 2011. Its objective is to contain the systemic risks emanating from SIFIs. To this end, the framework rests on two pillars: the first of these comprises better loss-absorbing capacity in comparison with other institutions. This is achieved by capital surcharges going beyond Basel III set according to the systemic importance of the given institution. The second pillar consists of mechanisms allowing the restructuring and resolution of SIFIs without plunging the financial markets into turbulence. The example of the recently nationalised SNS Reaal in the Netherlands shows the importance of putting in place regulations in this sector.

The SIFI framework was initially applied to globally systemically important banks. In a second stage, it was extended to banks which are systemically important at the domestic level. Finally, intensive work is being performed at present on transferring it to insurers and financial market infrastructures which are systemically important globally. In terms of its application, the framework is thus not restricted to a specific sector. Furthermore, it can be applied to banks which are systemically important internationally as well to banks that are not systemically important at the global level but at the domestic level. This means that the SIFI framework takes account not only of interlinkages across sectors but also of the close connection between national and supranational levels.

In designing the new Basel framework, Basel III, the close interlinkages in the financial system – between sectors as well as between jurisdictions – have to be taken into account in order to prevent regulatory arbitrage. This is because the new capital and liquidity standards for banks will not only lead to an increase in the quality and quantity of capital and an improvement in liquidity. At the same time, these more stringent regulations will potentially set incentives to shift transactions and thus circumvent the stricter banking regulation. I am thinking in this context not only of shifts into less strictly regulated jurisdictions but also, in particular, of transactions being shifted towards less strictly regulated players of the shadow banking system.

These examples also show clearly that we have already passed a number of important milestones in financial market regulation, but are still a long way from our destination. Progress in work on the various elements of the reform agenda is at different stages. Some reforms have already taken the form of planned legislation or have already entered into force; others will follow this year. Even so, we still have a lot to do.

Besides solving the “too big to fail” problem, developing comprehensive recommendations on the regulation of the shadow banking system is among the upcoming major projects this year. Here, I expect the publication of our final report in September. The future viability of the business models of a number of banks will also be subjected to scrutiny – not least against the backdrop of the ongoing discussion about the introduction of a model involving a separation of commercial and investment banking, or the Volcker Rule.

And then we also still have a lot of work to do on the regulation of OTC derivatives trading. The G20's original time schedule for implementing the recommendations on the reform of the OTC derivatives markets by the end of last year failed to be met. It is therefore all the more important not to ease off at this point but to press on resolutely with its implementation. Delays in the timetable cannot always be avoided. But they should not lead to the envisaged reforms being watered down. Otherwise, we would be jeopardising our goal of making the financial system as a whole more resilient to crises.

## 4. Consistent implementation taking centre stage

Although we still have a fair stretch of road ahead of us, the focus is rapidly moving away from the development of regulatory measures towards implementing them. In the future, monitoring their implementation will undoubtedly be shifting more and more to centre stage.

The reason for this is that, if the regulatory measures agreed at international level are to have their intended effect, it will be absolutely crucial for them to be implemented consistently in the individual countries as well. That also includes adhering, as far as possible, to the timelines agreed for their implementation so that competitive distortions are avoided as far as possible. To prevent the emergence of a regulatory gap, the regulations should be applied not only in the G20 countries but also, preferably, in all countries with developed financial systems.

Regulators and supervisors are aware of the importance of consistent national implementation. For that reason, we have significantly expanded our work in monitoring national implementation over the past few years. Thus, the self-commitment of the FSB members to lead by example in the implementation of international standards is subject to a regular review with publication of the results. In addition, for three years now, a system of peer reviews has been in place among FSB members to investigate the relationship between promise and performance or, in other words, how far the internationally agreed standards and principles have been implemented nationally. In cooperation with international standard-setting bodies, in October 2011 the FSB presented a coordinated framework for monitoring and reporting on the implementation of the agreed reforms. In this connection, greater attention is being paid to areas such as the Basel framework and measures relating to SIFIs, but also including the shadow banking system. In-depth monitoring and regular publication in the form of progress reports to the G20 are also helping to keep up the pressure for implementation.

In order to prevent regulatory arbitrage between sectors and countries, we have to fix our sights even more firmly on the systemic aspects of regulation. The key requirement for doing this is to assess the overall effects of the regulatory measures and to analyse any potential interactions between them.

Impact studies play a major part in gauging the macroeconomic effects of new proposed regulation. I therefore expressly welcome the fact that all the Basel reforms – including the new Basel III liquidity standards – are being accompanied by studies that assess both their short and long-term effects on banks and the real economy.

Repeated fears have been voiced from within the financial industry that the stricter Basel III regulations combined with the more far-reaching requirements for SIFIs will have the effect of restricting the credit supply. The Basel Committee has looked into this question and come to the conclusion that the drawbacks are outweighed by the advantages, namely the gain in stability and the reduced likelihood of future crises. A moderate increase in the cost of lending and minor losses in growth will thus not put at risk the supply of credit to the economy.

Pressing ahead with work on the various elements of the reform agenda in parallel harbours the risk that individual measures might conflict with each other. In our closely interlinked financial system, focusing on sector-specific measures can easily lead to unintended interactions occurring or even conflicting incentives being set. Such a lack of consistency might lessen the desired effects of the new regulations or even negate them entirely.

One possible instance of unwanted interactions is the combined effect of European banking regulation and the EU solvency regime for insurers. This is because banking regulation aims to place bank funding on a stable, that is a long-term basis, while, under certain conditions, the solvency regime gives preference to bank bonds with short maturities. Capital requirements increase relatively sharply given longer duration of the bank debt securities held by insurance companies – at least when the standard formula is used. The outcome might be that insurers change their asset allocation to the detriment of bank debt securities. As insurers are among the most important investors in bank bonds, this could ultimately lead to an increase in banks' funding costs.

Within a single sector, too, different regulations can set conflicting incentives. One example of this might be the interplay between the EU crisis management directive and the scheduled liquidity ratio requirements. This is because the draft proposals of the directive provide for short-term liabilities being excluded from bail-in, thus setting incentive for short-term funding. This is diametrically opposed to the aim of regulating liquidity, which is to safeguard the maintenance of liquid funds even under unfavourable circumstances and for longer periods of time.

Of course, a final judgement on the effects of each of the regulatory initiatives can only be made when their precise details are known and as soon as robust empirical evidence is available.

In the end, for the regulatory reforms to have their desired effect, it will be absolutely crucial that we identify any potential interactions of this kind and, as far as possible, avoid them. This is quite clearly anything but an easy task. It means weighing up the aims and effects of various measures. It could also mean that measures which have already been adopted have to be amended or revised while they are in the process of being implemented or soon after. The latest example of this is the revision of the liquidity standard by the Basel Committee. Having said that, however, it should be clear to both the general public and those affected by regulation that this is not a case of watering down measures once they have been adopted. Rather, it is matter of taking due account of systemic aspects of regulation so as to avoid possible unwanted consequences.

## 5. Conclusion

Ladies and gentlemen

The international regulatory agenda is not a patchwork. Rather, it represents an all-embracing approach covering a wide range of issues from institutions to financial markets to individual instruments. This coherent strategy consists of several interlocking structural elements, the overall impact and potential interactions of which have to be carefully analysed. For it is only with an internally consistent regulatory agenda that we can make the international financial system more stable and more resilient to crises.

In order to achieve this goal, the international agreements now finally also have to be consistently transposed into national regulations and laws. Even if slight delays to the original timetables cannot always be avoided, there should be no doubt about the determination of all the G20 countries, including the EU, to continue fulfilling their commitment to implement the reforms.

Thank you for your attention. I look forward to the ensuing discussion.