Andreas Dombret: Regulatory reform in Europe – mission accomplished?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Institute of International Bankers (IIB) Annual Conference, Washington DC, 2 March 2015.

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1. Introduction

Ladies and gentlemen

Thank you for granting me this opportunity to speak at the IIB Annual Conference. It is a pleasure to be here.

In my speech today, I want to answer the question whether the mission of regulatory reform in Europe has been accomplished. Allow me to begin with a quote from the movie "Mission Impossible": "Every search for a hero must begin with something which every hero requires, a villain".

For the topic of regulatory reform, I want to paraphrase that quote as follows: "Every search for a solution must begin with something which every solution requires, a problem". We all know that the problem in the banking system was the financial crisis and in my view, the solution is regulatory reform.

Let us therefore take a closer look at what has been done in post-crisis reforms in Europe and beyond.

2. The first mission: regulatory reform

One of the main lessons from the financial crisis was that the rules of the banking system were insufficient. We saw excessive risk-taking, insufficient loss absorbing capacities and banks that were "too big to fail" – just to name some of the problems that led to the crisis.

Over the last seven years since the collapse of Lehman Brothers, significant progress has been made on the regulatory agenda. The most important regulatory measure was the Basel III framework, which introduced stricter capital requirements and new liquidity rules. In Europe, we have done a lot of work to implement these requirements – first and foremost with the CRD IV and CRR. These rules safeguard harmonised implementation of the Basel III framework throughout all member states.

On a side note, the latest Basel III monitoring exercise is due to be published tomorrow. I am certain it will confirm the impression that most large internationally active banks already meet the fully implemented capital requirements. I am also quite optimistic that, on average, all internationally active German banks will fulfil the Basel III requirements with regard to the CET1 ratio. We should furthermore see that German banks have significantly improved their leverage ratios. In international comparison, there is still room for further improvements, however. But still, banks' loss absorbing capacity is far better than it was prior to the financial crisis.

When Basel III is fully implemented in 2019, regulatory capital requirements will be significantly higher and tougher than under Basel II, and I am sure that the financial system will be more stable than before. But are higher capital and liquidity requirements enough?

2.1 Some missions almost accomplished …

Certainly not. And therefore, besides the Basel III regime, many other regulatory projects have been tackled in response to the financial crisis. Let me mention three of the most current ones: regulation to solve the "too-big-to-fail" problem, regulation of sovereign exposures and efforts in regulating the shadow banking system.

We all know that one problem of the crisis was that banks were perceived as being "too-big-to-fail". The consequence was the perception that whenever a "too-big-to-fail" bank runs into trouble, the government might be compelled to bail it out in order to prevent a financial crisis. This means that these banks were implicitly insured – contrary to all market-based economic principles.

So, the decisive point is that banks must be able to fail without dragging the entire financial system down with them. What we need, therefore, are effective resolution mechanisms for banks. And the regulators are working on that problem.

At the global level, the G20 have just agreed to a proposal that global systemically important banks will have to fulfil in future regarding their capital structure. In particular, these banks will need to ensure a minimum amount of total loss-absorbing capacity, TLAC for short, which may be as high as 20% including the minimum capital requirements and the G-SIB buffer. This will make global banks more resilient, and it will allow for their orderly resolution.

Work on TLAC is making good progress. Last November, the FSB published a consultative document on TLAC. At the moment, impact assessment studies are being conducted in order to gauge the effect of TLAC on global systemically important banks. I am quite optimistic that we can finalise the requirements by the end of 2015.

It goes without saying that the final rule must not be less stringent than what the G20 leaders agreed upon in Brisbane. We need a binding international minimum standard of at least 16–20% of risk-weighted assets.

At the same time, the Financial Stability Board (FSB) is working on requirements for cross-border resolution. When this framework, consisting of TLAC and cross-border resolution mechanisms, is in place, the problem of "too-big-to-fail" will be tackled effectively.

2.2 … others have just been launched

A second problem that eventually arose during the European sovereign debt crisis was the close nexus between states and banks. Under the current regime, banks usually do not need to hold capital against the risks of loans to sovereigns – unlike other loans. This regime is based on the assumption that loans to governments are risk-free because states cannot default. And therefore, it is not necessary to establish capital buffers.

All those who had trouble following that line of argument saw their doubts confirmed by the sovereign debt crisis in Europe. We obviously need to rethink the assumption that loans to governments are risk-free.

Consequently, it appears urgently necessary to change the rules. If banks were required to hold capital against the risks of their government bond portfolios, that would make them more resilient to fiscal distress. At the same time, banks would have less incentive to buy large volumes of government bonds.

And this brings us to the second issue: capital alone is insufficient. A crucial tool of risk management is diversification. A cap on loans to an individual sovereign should therefore also be introduced.

A large exposure regime of this kind was already introduced for loans to the private sector some time ago. Large exposure caps prevent banks from becoming overexposed to a single borrower. This makes them less vulnerable to the default of that borrower – and this is needed not just for private borrowers but for government borrowers as well.

The Basel Committee on Banking Supervision started its work on sovereign bonds last December. I believe the following points are crucial and need to be addressed within the next few months.

- First, the zero-weighting of sovereign exposures should be replaced by an adequate underlying with equity.
- Second, regulation of large exposures should also apply to sovereign bonds.
- Third, we need enhanced disclosure requirements for risk positions in sovereign portfolios.
- And fourth – and this is of crucial importance for me – regulation of sovereign exposures must be consistent throughout all credit institutions and all sectors of the financial system.

2.3 … and others again seem to be really hard to accomplish

When speaking about the regulatory reform, we have to bear one important thing in mind: all the reforms I just mentioned only reach the regulated banking sector. And tightening regulation for banks might set off a trend to shift activities out of the regulated banking sector into the unregulated shadow banking sector. This development is something regulators have to watch closely.

Without any doubt, shadow banks can become a source of systemic risk, especially when they are highly interconnected with the regular banking system. It is therefore of the utmost importance to monitor shadow banks' activities and try to regulate them adequately. At their 2014 Brisbane summit, the G20 agreed on a new roadmap for regulating the shadow banking sector. Work is being conducted simultaneously by the FSB, the Basel Committee and IOSCO.

But the ambitious reform agenda is far from completed. In my view, a key task on the way towards transforming shadow banking into resilient market-based financing is now to identify areas where additional FSB recommendations are needed and where existing recommendations should be made more precise. We have to bring forward this reform agenda with all our efforts.

Let me conclude the discussion of regulatory reform with something that seems very important to me. Each of the regulatory projects I have discussed calls for international cooperation. If we do not coordinate our approaches towards regulation, we will create a fragmented financial system with vast opportunities for regulatory arbitrage.

When all is said and done, we all pursue the same objective: a stable financial system – certainly at the national level, but it is equally important at the global level. As European and US regulators, we therefore must work together in an effort to avoid any form of fragmentation of the regulatory space. The issue of derivatives oversight is just one example of where international cooperation is essential.

3. The second mission: supervisory integration in Europe

Ladies and gentlemen, I have discussed some of the regulatory answers to the financial crisis. But regulation is only one answer to the crisis. The crisis has also shown that banking supervision failed to keep pace with the increasingly international developments in the banking sector. Instead, it remained confined within national borders. In Europe, the response to this observation has been a leap in integration.

This leap in integration is mainly characterised by the establishment of the European banking union, which will comprise of a single supervisory mechanism, a single resolution mechanism and harmonised deposit insurance.

The single supervisory mechanism, the first pillar so far, went to work on 4 November 2014. On that date, the ECB assumed responsibility for supervising the 120 largest banks in the euro area – with the accession of Lithuania, the number of supervised banks has risen to 123. These 123 banks account for more than 85% of the aggregate balance sheet of the euro area's banking sector, making the ECB one of the biggest banking supervisors in the world.

Taking banking supervision from the national level to the European level has three specific benefits.

First, it introduces more harmonised supervision standards. Under the SSM, European banks will be supervised according to the same high standards. These standards will be developed by sharing experiences across borders and cherry-picking the best practices from national approaches to banking supervision.

The second point is that the SSM will effectively supervise banks in a truly cross-border manner. Although home-host collaborations and supervisory colleges for international banks have existed for some time, they are no substitute for genuine cross-border supervision. European supervision will provide precisely this because only one supervisor is in charge and is really in possession of the full picture. This is essential today because large banks are usually internationally active.

Third, transferring banking supervision from the national to the European level will put greater distance between supervisors and the banks they supervise and therefore minimise any home bias. Therefore, European banking supervision will reduce the likelihood of national supervisors affording preferential treatment to "their" banks, thus contributing to prudential transparency.

Despite all the advantages that European banking supervision offers, you may be under the impression that Europe has entered into uncharted territory by transferring responsibility for banking supervision to the ECB, an institution with no previous experience in supervising banks at all. Be assured that this is not the case.

National supervisors continue to play an important role in supervision within the Single Supervisory Mechanism. Responsibility for supervision lies with so-called joint supervisory teams. These teams are headed by ECB staff, but mainly consist of national supervisors. And I must say that our experience during the first months of the SSM has been quite positive.

As I pointed out earlier, establishing the Single Supervisory Mechanism is only the first pillar of the European banking union. Banking supervision cannot and should not prevent individual banks from failing – either at the national level or at the European level. The possibility of failure is an essential element of a well-functioning market economy.

Nonetheless, one lesson we learned from the financial crisis is that the failure of very large or interconnected banks could lead to a systemic crisis. Thus, as I have already mentioned, solving the "too big to fail" problem is crucial in order to make the financial system more stable and save taxpayers' money.

And this is where banking supervision has to be flanked by other measures and where the second pillar of the European banking union – the Single Resolution Mechanism – comes in. From 2016 onwards, European banking supervision will be supplemented by a European Single Resolution Mechanism for banks. From then on, the banking union will rest on two pillars and provide a stable framework for European financial markets.

4. Conclusion

Ladies and gentlemen, let me return to the beginning of my speech. With regard to regulatory reform we might ask: mission accomplished or mission impossible? At the end of the day, the most probable answer is: a bit of both. Regulatory reform will never be completed because the financial system is evolving constantly and regulation has to keep pace.

At the beginning of my speech, I identified the crisis as being the problem in the banking system and regulatory reform as the solution. To be sure, there are many people in this world whose profession it is to invent problems in order to sell expensive solutions.

As far as financial regulation is concerned, the problem at hand is real: a financial crisis that brought the financial system to the brink of collapse and imposed huge economic and social costs on many people. It is rather obvious that regulators did not invent the problem, and, equally important, the solution we propose is not expensive when measured correctly.

I do not deny that stricter regulation translates into higher costs for banks. However, when measured against the burden that financial crises place on society, these costs seem to be justified.

But regulation and supervision are only one side of the coin. If we want the banking system to become a safer place, banks managers' behaviour will also play an important role. What we need is a change of culture. The times of "greed is good" should be long gone. We should see the financial system for what it actually is: a service provider for the real economy. Subscribing to this notion of finance will probably be the most important step towards a more stable banking system.

Thank you for your attention.