Philipp Hildebrand: Banking regulation – changing the rules of the game

Speech by Mr Philipp Hildebrand, Vice-Chairman of the Governing Board of the Swiss National Bank, at the Twelfth Annual International Banking Conference, Federal Reserve Bank of Chicago, Chicago, 25 September 2009.

I would like to thank Jürg Blum, Rita Kobel, and Signe Krogstrup for their valuable support in drafting this speech. I also want to thank Bertrand Rime for helpful comments and discussions.

* * *

Introduction

I want to thank the Federal Reserve Bank of Chicago for the kind invitation and the opportunity to speak to you this evening. It is a privilege to be here. A year ago, we were in the midst of a perfect financial storm. Following the bankruptcy of Lehman Brothers in mid-September, the imminent collapse of the global financial system became a distinct possibility. To avert such an outcome, a bold and unprecedented international policy response was needed and promptly initiated. In the US as well as in Europe, several of the world's largest financial institutions required public capital injections, and their nondeposit liabilities had to be guaranteed. A number of countries were forced to expand their deposit insurance programs. In some cases, governments or central banks purchased or guaranteed bank assets.[1]

In spite of the rapid policy response aimed at stabilizing the global financial system, the broader economy was heavily hit. Trade and industrial production literally fell off a cliff. In the fourth quarter of 2008 and the first quarter of 2009, global economic activity recorded its weakest performance in decades.

Today, the situation has improved very significantly. The unprecedented global policy response has had its intended effect. The financial system is showing clear signs of stabilization. Incoming economic data over the last couple of weeks suggest that global economic activity is improving. The economic rebound in the coming months may even exceed expectations. At the same time, looking beyond the near term horizon, our economies and the financial system continue to face considerable uncertainties and challenges. Yet, certain parts of the financial industry appear tempted to go back to business as usual. Industry statements and comments made by some banks on regulatory reforms reflect this trend.

Ladies and Gentlemen, I am deeply convinced that it is our common responsibility and duty not to let this happen. Let me begin by laying out three hopefully compelling reasons why we must secure fundamental regulatory reform of the financial sector.

The first reason is that too much of the risk taken in the financial sector ultimately resides with taxpayers. The rescue of significant parts of the global financial system from near-certain collapse by public authorities came at very substantial risk and costs to taxpayers. According to data collected by the Bank for International Settlements, here in the United States, for example, the total potential costs of various support measures taken – capital injections, asset purchases, and guarantees of bank debt – amount to about 40 per cent of GDP. For some European countries, these numbers are even higher. While in some cases governments and central banks have been able to reduce their exposures, sometimes even with a profit, the involvement of the public sector remains important. The ultimate outcomes of these involvements are uncertain. Moreover, the consequences of the crisis in terms of job

---

[1] Ben S. Bernanke gave a thorough overview of the various measures taken worldwide in his speech "Reflections on a Year of Crisis" at the Federal Reserve Bank of Kansas City's Annual Economic Symposium, Jackson Hole, on 21 August 2009.

and wealth losses, huge increases in discretionary and non-discretionary public spending, and dramatic declines in public revenue is bound to be enormous. In some countries, public debt is set to rise at a pace never seen before in peace time. At the end, the citizens of our respective countries will have to foot the bill, one way or another.

The second reason is that the crisis also generates important intangible costs which are often overlooked. Confidence in the financial sector and those running it has been severely damaged. Moreover, because a small number of individuals have dogmatically equated markets with the unbounded pursuit of short-term profits, faith in the benefits of a market-based economic system has been undermined. Finally, the extraordinary public policy response to the crisis has potentially prepared the ground for even more moral hazard in the future.

The third reason is that this financial crisis will not be the last one. Between 1973 and 1997 alone, there were 139 documented financial crises in various parts of the world.[2] Some suggest that we should redesign the global financial system in such a way that there will never be a financial crisis again. This is neither desirable nor realistic. As long as we want a financial system that performs a meaningful and useful function for the real economy, we will have to live with financial cycles. Moreover, the current crisis has clearly demonstrated the limitations of complex regulations and models. Even the most complex models will never be infallible. What we can and should do is to limit the likelihood of and the fallout from future crises.

It would be an inexcusable mistake to miss this opportunity to see through fundamental regulatory reform. We have to address the vulnerabilities that were at the root of this crisis and are likely to be at the root of those in the future. For this purpose, we need simple, effective measures that can be implemented rapidly once the crisis is over.

There are intensive efforts under way to increase the resilience of the financial system. With the support of the G20 leaders, the Financial Stability Board (FSB) has initiated an impressive number of reform projects.[3] Good progress has been made on many measures. In some important areas, however, decisions have yet to be taken. In line with proposals by the FSB, I believe we need to pursue a dual-track approach to reforming the global financial system, combining preventive measures with measures facilitating the orderly resolution of large international banks in the event of a future crisis.

An ounce of prevention

We have all been told that an ounce of prevention is worth a pound of cure. Considering the enormous costs associated with the cure of the current crisis, this holds especially true when it comes to financial stability. Most importantly, we need to strengthen the shock absorbers of the financial system. In the context of banks this means that they have to hold more capital and more liquidity. Strengthened shock absorbers in the form of higher capital and liquidity buffers have several beneficial effects.

Bigger buffers enable banks to absorb larger negative shocks without triggering an idiosyncratic, let alone a systemic crisis. Furthermore, bigger buffers ensure that banks themselves bear a larger share of their downside risks. Not only does this reduce the potential burden for taxpayers, but it also creates stronger incentives for the banks themselves to operate prudently. If shareholders know that they have to absorb potential

---

[2] Barry Eichengreen and Michael D. Bordo: “Crises now and then: What lessons from the last era of financial globalization?”, *NBER working paper 8715*, January 2002.

[3] “Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience”, April 2008, and the recommendations and principles to strengthen financial systems that the FSB published on 2 April 2009.

future losses rather than passing them on to taxpayers, they will likely become less willing to let management engage in excessively risky activities. Ultimately, this incentive effect can help make future crises less likely.

Strengthening capital requirements

The crisis has nakedly exposed the dangers of excessive leverage. It also revealed a number of fundamental weaknesses of existing capital requirements. While model-driven risk-weighted capital requirements are sensible and should be maintained, they are not perfect and very likely never will be. Most of us have had to learn the hard way that the modeling of risk involves substantial risks itself. Despite risk-weighted capital ratios that in most cases exceeded the regulatory minima, leverage was a key source of vulnerability going into the crisis. Excessive leverage not only intensified the impact of mistakes on the financial situation of individual banks. It also amplified the crisis as ongoing deleveraging in the industry inevitably put downward pressure on financial markets and on the real economy.

It is now also clear that banks were undercapitalized at the start of the crisis. Mounting losses quickly depleted their capital base, and, with a few notable exceptions, the banks found themselves in desperate need of massive support measures by the public sector.

To address these weaknesses, a considerable amount of work has been done and is still underway in the FSB and in a number of working groups of the Basel Committee on Banking Supervision. In line with, and in full support of these efforts, I am convinced that a more robust capital framework needs to be built around the following features:

- The amount and the quality of capital have to be increased very substantially. Capital buffers need to be high and robust enough for banks to survive a crisis on their own and thus to foster confidence in the system as a whole. In the medium term, this will be feasible without causing drastic adjustments at banks that might be harmful to the real economy. Looking at the banks that received public support, many of them paid out more in dividends and share buybacks during the years preceding the crisis than they subsequently faced in losses.
- As a supplement to the risk-based capital requirements, a simple and commonly defined leverage ratio restriction needs to be introduced. A leverage ratio prevents the buildup of excessive leverage and serves as a backstop to the complex, but fallible risk-based capital requirements.
- To address procyclicality, banks will have to build up capital buffers above the minimum requirements in good times. In difficult times, banks will be allowed to fall significantly below the target levels defined for good times. Allowing banks to draw down capital without violating any minimum requirements helps to mitigate the harmful effects of deleveraging.

Overall, regulators must no longer allow banks, especially systemically important ones, to operate at such worryingly low capital levels as have been observed in the buildup of the current crisis. At the beginning of this month, the finance ministers and central bank governors of the G20 were very explicit on this.

More robust liquidity requirements

The crisis has also provided a number of important lessons regarding liquidity. In short, banks' liquidity holdings were insufficient. This holds true for the quantity but also for the quality of liquidity. One of the explanations for these insufficient holdings of liquidity was that the stress scenarios considered by banks were far too optimistic. While secured funding remained the most stable source of refinancing, it was much less stable than what banks and regulators had assumed. Moreover, it quickly became apparent that liquidity problems at single banks imposed considerable stress on the entire international system.

As in the area of capital, the FSB and the Basel Committee are working at full throttle towards an internationally coordinated liquidity standard for banks. In my view, this internationally harmonized standard needs to have the following basic features to be effective:

- The standard should reflect a very adverse scenario, including a massive loss of confidence from depositors, a disruption of secured funding and a loss of liquidity on major segments of the securities markets. The new standard will only be able to promote stability if the underlying scenario is severe enough. A moderate scenario is not sufficient to bolster confidence in situations of turmoil.
- The standard should require banks to hold a buffer consisting of assets whose liquidity and value is robust to massive disruptions in the financial markets. The presumption should be that government securities form the bulk of the buffer.

Overall, the new liquidity standard should substantially strengthen banks' liquidity base. Banks must be in a much better situation to weather liquidity shocks without having to resort to public support.

As a consequence of these higher capital and liquidity buffers, the relevant banks may seem more boring. Their rate of return on equity will be lower. At the same time, their earnings are bound to be less volatile and they will likely be more beneficial for the economy as a whole. With such changes must come a change in banks' compensation policies and practices. Compensation cannot be a one-way street and must become risk aligned and long-term oriented.

Facilitating the orderly resolution of banking problems

Prevention is key but it will not be foolproof. Even with these better shock absorbers in place, large and systemically important banks will again experience severe financial stress at some point in the future. Here we must accept that we still have not dealt with the fundamental reason why systemically important banks cannot be allowed to fail. The truth is that, if tomorrow morning a systemic institution were to be on the brink of failure, we would again face the terrible choice of coming to its rescue or risking the stability of the financial system.

The fact that financial institutions which are too big or too interconnected to fail exist is a flagrant contradiction of one of the key principles and beliefs on which any market-based economy is built: Competition should ensure that the most efficient – and not the largest and most risk-loving – survive in the market place. It is evident that a change of rules is required. The financial system of the future should expose financial institutions of all sizes and structures to the test of the market place. In the event that some of them fail, we need a system that allows for the orderly resolution of large and complex financial institutions. In other words, we require a system that permits us to let systemically relevant institutions fail safely.

One of the principal hurdles to achieving this objective is that it requires international coordination. Many of you will argue that the notion that we could agree on an international framework for the orderly resolution of cross-border financial institutions is utopian. Your skepticism is understandable. After all, much work has gone into trying to address this problem for at least 30 years, arguably with little concrete success. The many technical and legal problems have impeded any meaningful progress.

Despite this unfortunate track record, I would argue that the real problem has not simply been a lack of technical answers to admittedly very difficult problems. After all, where there's a will, there's a way. What we urgently need now is the political will to address the technical difficulties and to cooperate internationally in pursuit of a solution. In 1961, President

Kennedy announced to the world that the United States would go to the moon before the end of the decade. At that point, the NASA engineers clearly hadn't solved all technical problems associated with landing a man on the moon. It seems to me that the key to solving these problems was a clearly stated political objective. Much like John F. Kennedy's commitment nearly 50 years ago, we now need a bold and international political commitment to put in place a framework for the orderly resolution of cross border financial institutions. Provided we have such an unequivocal commitment, solutions will eventually emerge.

A new framework needs to ensure that a failing bank can continue to fulfill the functions that are critical for the functioning of the economy. It needs to provide regulatory tools that will help reduce the size and complexity of systemic institutions. This will require a close dialogue and meaningful cooperation between the public authorities and the banks. The framework should also prevent destabilizing effects of a failure on the rest of the financial sector – for example by building and improving on financial market infrastructures that reduce counterparty credit risk. Ultimately, however, it must not exclude the possibility that a large and complex cross-border financial institution can be – and should be – subject to insolvency proceedings where reorganization is not possible.

Of course, we must accept the reality that different national resolution regimes will continue to coexist. To make it perfectly clear: I am not proposing to create a global resolution regime to replace national regimes. Such an endeavor strikes me as the equivalent of a journey not to the moon, but to outer space. But that should be no excuse for not improving the framework for cooperation across the relevant countries.

Concluding remarks

The worst of the crisis is behind us, and there are intensive efforts under way to increase the resilience of the financial system. Banks are again generating profits and, in some cases, very substantial profits, not least because of the costly public support measures, many of which remain in place. As the situation improves, complacency can easily become the rule of the game. We forget the severity of the crisis and fall prey to renewed lobbying of a powerful and recovering industry. We must not let this happen. Strong and bold entrepreneurial and political leadership is now required to see the necessary changes for the financial system through, as demonstrated today by the G20 leaders in Pittsburgh. Clearly, there are many areas in financial regulation that can and in many cases should be improved. Given what is at stake, there is clearly a need to prioritize. I have briefly laid out to you this evening where I see those priorities. Thank you for your hospitality and patience.