Thomas Jordan: Bank regulation – what went wrong? What will improve?

Summary of a speech by Mr Thomas Jordan, Vice-Chairman of the Governing Board of the Swiss National Bank, at the Forum für Universität und Gesellschaft, Berne, 24 March 2010.

The complete speech can be found in German on the Swiss National Bank's website (www.snb.ch).

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The financial crisis has caused enormous damage. Massive losses were recorded in the global banking system. Many countries have gone through the worst recession since the Second World War. Government rescue measures had to be implemented to stabilise the financial system. Existing bank regulations were not able to prevent the crisis, nor were they able to at least contain the damage to such an extent that government rescue packages would not have become necessary.

While before the financial crisis, there was considerable uncertainty about possible shortcomings in bank regulation, these have now become apparent and will have to be tackled. In addition, the provision of implicit state guarantees has made the need for action even more urgent. Big banks – believing that they will receive government assistance if they run into problems – have even stronger incentives now to take on excessive risk. This increases the risk of another crisis and erodes the fundamental principle of the market economy – competition. Once again, in the future, banks will have to bear their own risks. The failure of a bank should no longer jeopardise the stability of our financial system. Only then, will our financial system become less prone to risk and will the extent of future crises clearly decrease.

In order to achieve this goal, several measures have been decided on in Switzerland. First, new capital adequacy requirements were enacted in 2008. Big banks will have to double their risk-weighted capital. In addition, they will have to hold a minimum amount of equity capital, irrespective of the risk models they use internally. This is because the crisis has shown that internal risk models massively underestimated the risks taken. Second, new liquidity regulations will be adopted. In the future, big banks will have to hold a sufficient amount of high-quality liquid funds to be able to cover unexpected liquidity losses for a period of at least 30 days. The reason for this is that, in the financial crisis, even solvent banks had liquidity problems. Finally, measures to solve the "too big to fail" issue must be put into practice. No bank should be so systemically important that governments feel forced to rescue it from impending failure, fearing the economic costs such a failure would cause. Possible solutions to the "too big to fail" issue are the creation of incentives to encourage banks to reduce their size or change their organisational structure.