Axel A Weber: The G20 agenda on financial regulation

Dinner speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the International Conference on Financial Market Regulation, Berlin, 19 May 2010.

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1. Introduction

Ladies and gentlemen,

These days it is hard to find a topic that is suitable for a light-hearted dinner speech. One could either choose to talk about a crisis-related topic, which would mostly be unpleasant, or one could choose to talk about something completely different and run the risk of appearing slightly out of touch with reality. As a compromise, I have decided to talk about one of the more positive outcomes of the crisis – assuming that "positive" is not a misnomer. As devastating as the crisis has been, it has set in motion a process of reform that will eventually lead to a more stable and resilient financial system in the future. Originally, I wanted to give you a short overview of the state of these reforms. And even though I will stick to that plan, current events have to be acknowledged and I will do this at the end of my speech.

2. Major issues of reform at the micro and macroprudential level

The reform of financial regulation was initiated by the G20 during various meetings in London, Washington and Pittsburgh. Having devised the general objectives, the G20 then commissioned the Financial Stability Board and the Basel Committee on Banking Supervision to draw up proposals as to how these objectives could be met. The overarching principle of reform is to create a financial system that is more stable, more resilient and thus more capable of absorbing potential shocks.

Any attempt to achieve this objective has to begin with the individual institution – that is, at the microprudential level. Preventing individual institutions from failing would serve as a first line of defence against systemic crises. Regulation at the microprudential level centres on the Basel II framework, which was launched in 2004 and has been implemented by a large number of countries. In a nutshell, the Basel II rules require banks to provide risk-adjusted capital and liquidity buffers. These buffers serve to absorb potential losses and help to prevent failures. Thus, an enhanced Basel II framework would further strengthen the first line of defence against future crises.

Relevant proposals were put forward in December 2009, including, among other things, measures to raise the quality, consistency and transparency of the capital base, a global standard for funding liquidity, and the introduction of a leverage ratio. Throughout 2010 the proposed measures will be calibrated on the basis of an extensive quantitative impact study. The fully calibrated set of measures will then be issued by the end of 2010 and the new standards will be phased in by the end of 2012 provided that economic recovery is assured.

The proposed measures will certainly help to reduce the likelihood of individual bank failures. However, even though such events have proven capable of destabilising the whole financial system, totally eliminating the risk of failure would be highly detrimental to growth and efficiency. Regulation at the microprudential level therefore has to be supplemented by a macroprudential stance that takes into account the stability of the financial system as a whole, thus constituting a second line of defence against systemic crises. A major concern in that respect is the treatment of systemically important institutions, as their failure might lead to system-wide disruptions.

When approached at a more detailed level, the concept of systemic relevance proves to be rather complex. Contrary to common perception, systemic relevance is driven by more than the sheer size of an institution. Factors such as interconnectedness, substitutability and the state of the markets also determine whether the failure of an individual institution will have a systemic impact – the banks that played a core role in the crisis were actually often not that large. Consequently, we need to put some effort into finding a reliable way of identifying systemically important institutions, and we might also have to accept that systemic relevance is not a zero-one criterion.

The difficulties do not stop there. Once an institution is defined as systemically relevant, moral hazard problems might occur. As the institution in question would most likely be aware of the fact that it cannot be allowed to fail, it would have every incentive to engage in risk-prone behaviour and gamble on being bailed out as soon as it gets into trouble. Any measures aimed at systemically important institutions must therefore take into account the moral hazard dimension.

The reform of the Basel II framework is certainly part of the solution to this problem, as it will help to improve the capacity of systemically important institutions to absorb losses without creating moral hazard. However, what is required is a more comprehensive approach which specifically ensures that accountability is brought back into the game. Major proposals that go beyond the reformed capital and liquidity framework include capital surcharges for systemically important institutions, better resolution regimes and a strengthening of the financial infrastructure. Commissioned by the G20, the FSB is already working towards that goal.

3. Some thoughts on the most recent backslide on the financial markets

I could have closed my speech with this rather positive outlook not even two weeks ago. However, since then the crisis has again raised its head, this time exposing the weak position of government budgets in some euro-area countries. At first sight, the current problems seem to be rather different from what we experienced during the financial crisis. However, a second glance reveals that the underlying causes are quite similar, and so are the remedies.

Just like the financial crisis itself, the current problems can be traced back to a limited number of factors. First, a credit boom due to lower interest rates once the countries in question had joined the euro area. Second, insufficient or totally absent risk management in economic policy, which should have been much more countercyclical. And third, the Stability and Growth Pact was not applied as strictly as it should have been, or was weakened by questionable accounting practices and faulty statistics.

Given these similarities with the root causes of the financial crisis, the responses of economic policy are similar, too. The first challenge has been to stabilise the situation. The relevant steps towards that goal were taken by the Eurosystem and the Ecofin ten days ago. In particular, the commitment of fiscal policy to stepping up frontloaded consolidation efforts shows the will of the member states to tackle the current crisis at its root.

What must follow are structural reforms in a similar vein to those that I have just described with regard to the financial sector. It is essential to strengthen the existing fiscal rules to prevent individual countries from running into budgetary difficulties. Relevant proposals to enhance the Stability and Growth Pact have already been put forward. They could be complemented by national fiscal rules similar to the national debt brake in Germany. In addition, we might – over the medium-term – also think about devising mechanisms to limit the systemic impact of sovereign debt crises that might still occur. However, particular caution is warranted in this regard given that adverse incentive effects would most likely be even more severe than in the financial sector. For example, a permanently available support scheme would only exacerbate these problems and therefore should not be a policy option.

4. Conclusion

Ladies and gentlemen

Three years into the crisis, the necessity for a reform of financial regulation has been well understood at a global level. Until now, a number of relevant proposals have been put forward by international bodies such as the Financial Stability Board and the Basel Committee on Banking Supervision. Once implemented, the proposed measures will help to create a more stable and more resilient financial system. The events that reached their climax ten days ago emphasised the need for ambitious consolidation efforts and reforms in the fiscal policy framework in order to deliver sustainable public debt levels. In both cases, policymakers now have to muster the political will to take the necessary steps, however contested and painful they might be.

Thank you for your attention.