Andreas Dombret: Global financial market regulation – need for a coordinated implementation and a global level playing field

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a seminar of the European Ideas Network and centre-right Think Tanks and Political Foundations in Europe "Long-term growth – organizing the stability and attractiveness of European financial markets", Berlin, 20 January 2012.

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1. Introduction

Ladies and gentlemen,

Thank you for giving me the opportunity to introduce this round table on global financial market regulation.

2. Cornerstones of the international reform agenda are in place

To begin with, I wish to establish the fact that important cornerstones of the international financial reform agenda are in place. As examples of what has been achieved, take the new regulatory standard for bank capital adequacy and liquidity – "Basel III" – and the policy framework for dealing with systemic important financial institutions, the so called SIFIs. With regard to the latter, policy development is currently progressing on how to extend the framework from global SIFIs to non-bank and domestic SIFIs.

3. Consistent implementation

While rule-making at the global level is a necessary prerequisite for a global level playing field and financial stability, it is by no means sufficient. Rather, for the agreed reforms to be effective, they have to be translated into national laws and regulations in a globally consistent fashion and according to agreed timelines.

Consistent global implementation is also highly relevant with respect to the ongoing debate on the introduction of a financial transaction tax. If not introduced globally – or at least at the most important financial centres – such a tax would set incentives to relocate either parts of the business or firms altogether. In turn, actual revenues generated by the tax will probably be lower than projected and competition between financial centres be distorted. I urge the governments to make final decisions regarding a financial transaction tax as the market place would benefit from clarity on this issue.

Individual countries might also be inclined to generate competitive advantages for market participants or financial centers domiciled in their jurisdiction at the expense of others by implementing internationally agreed reforms only half-heartedly, or belatedly. Yet, they should be aware that these assumed gains in competitiveness may be short-lived – until another crisis strikes.

4. Intensified implementation monitoring

To prevent jurisdictions from pursuing such policies at the expense of others, implementation monitoring is being intensified at the international level. By means of peer pressure and transparency, rigorous monitoring can contribute to ensuring a global level playing field.

The results of numerous monitoring exercises are summarised in regular scoreboard and progress reports to the G20. In addition, international standard-setting bodies are stepping up their implementation monitoring instruments. To better coordinate the various mechanisms, the Financial Stability Board, or FSB for short, and the relevant standard-setting bodies have jointly developed a coordinating framework. Within this framework, six areas have been designated as deserving priority implementation and particularly intensive monitoring.

I will now briefly address four of these priority areas – leaving out those dealing with SIFIs as another round table today is dedicated specifically to the regulation of SIFIs.

a. Basel framework

First, the crisis made painfully clear that banks' equipment with capital and their liquidity positions were inadequate to withstand shocks to the financial system. The new regulatory standard Basel III will improve the resilience of individual banks with respect to both their capital and liquidity positions.

Basel III allows some discretion in national implementation: For example, the transition period permits jurisdictions to determine how quickly they adopt the new rules – which will depend on both the state of the national financial system and the macrofinancial environment. Moreover, as Basel III is an international minimum standard, jurisdictions might adopt tougher rules than the internationally agreed versions. Considering the significant differences in the size of banking sectors relative to domestic economies and the implied potential consequences in case of bank failures, I believe this to be a sensible approach.

At the same time, it poses the danger of inconsistent implementation and of raising prudential or level playing field issues. Therefore, the Basel Committee on Banking Supervision (BCBS) will monitor on an ongoing basis the status of jurisdictions' adoptions of the Basel rules, following a three-level approach: First-level assessments focus on whether the rules are adopted according to the agreed timelines while the second level deals with the content of the domestic rules. The third level extends the analysis of domestic rules to supervisory implementation at the individual bank level to assess whether they are delivering comparable outcomes. Initially, third-level assessments will focus on the calculation of risk-weighted assets across banks and jurisdictions.

As the adoption of Basel III – in contrast to its predecessors – has been fully integrated into the political process, the commitment to implement the new rules is extremely high. Europe is playing a pioneering role in the adoption process via the Capital Requirements Directive IV. I am confident that the comprehensive monitoring by the BCBS will be supportive in avoiding delays or departures from the agreed implementation plan in other jurisdictions.

b. Compensation practices

A second priority area addresses the widely acknowledged fact that inadequate compensation practices prior to the crisis led to excessive risk-taking and short-termism in financial institutions.

To safeguard financial stability, remuneration systems in the financial sector must be better aligned with the long-term performance of firms. With the Principles for Sound Compensation Practices and their Implementation Standards, the FSB developed corresponding guidelines.

The 2011 FSB Peer Review on compensation practices concluded that overall good progress had been made in implementing the Principles and Standards. At the same time, the review highlighted that level playing field issues exist among supervisors and institutions.

In response, the FSB is developing an ongoing monitoring mechanism to identify gaps and impediments to full implementation. As part of that, a bilateral complaint handling process between supervisors is being established to address level playing field concerns raised by institutions.

c. Shadow banking system

A third priority area deals with the so called shadow banking system. This is becoming more important because stricter regulation of the banking sector is setting incentives to move business into lightly or not (or not yet) regulated parts of the financial system. To ensure a level playing field with the banking sector, intensified monitoring and regulation of shadow banking activities is warranted.

The FSB set out recommendations for effective monitoring which are now to be implemented by national authorities. Additionally, monitoring exercises to assess global trends and risks in the shadow banking system are conducted annually.

Meanwhile, work at the international level is ongoing to examine potential gaps and inconsistencies of the current framework and to develop proposals on further regulatory measures on different parts of the shadow banking system, including money market funds, securitisations and repos.

d. OTC derivatives markets

The last priority area I am addressing is reforms in Over-the-Counter (OTC) derivatives markets. The global spillovers in the aftermath of the Lehman Brothers' failure have impressively illustrated that OTC derivatives markets can be a source of systemic risk due to their size and low degree of transparency.

The complexity of the markets and the lack of a single standard-setting body make regulation highly challenging. Accordingly, policy development is still ongoing.

Even so, G20 member jurisdictions have already committed to new rules for OTC derivatives markets to be in place by late 2012. These include standardised contracts, central clearing on exchanges or organised platform trading, reporting of transactions to trade repositories and higher capital requirements for non-centrally cleared derivatives.

However, few jurisdictions have the necessary legislations and regulations in place yet. While the EU has made some progress with respect to the European Market Infrastructure Regulation (EMIR), legislation in the US is still outstanding. In all jurisdictions technical standards and details are yet to be developed and actual implementation will take longer than originally planned. The delay and the lack of a robust global policy framework increase the probability of incomplete or inconsistent implementation of the agreed rules.

5. Closing remarks

Lagging reforms – like in OTC derivatives markets – show the need to continue exerting pressure on jurisdictions to push forward with financial sector reforms. Accordingly, the focus at the global level is increasingly shifting from policy development to implementation monitoring. Jurisdictions and authorities should be aware that they are under increasing scrutiny of the international community. For effective and timely national implementation of internationally agreed rules, political support remains essential.

As I have argued, rigorous implementation monitoring by international bodies is indispensable for ensuring global level playing fields in financial market regulation and achieving the goal to counteract financial stability risks.

I am looking forward to the ensuing panel discussion.

Thank you for your attention!