Andreas Dombret: Total Impact – how regulation and crisis management will change the world's financial landscape

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Frankfurt Finance Summit, Frankfurt, 19 March 2013.

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1. Introduction

Ladies and gentlemen

I am delighted to conclude this year's Frankfurt Finance Summit. For the third year in a row, this event has provided an excellent platform for an exchange of views between high-level experts from politics, academia, as well as the financial and the official sectors to discuss financial market issues of major current importance.

Today's conference has been asking about the total impact that regulation and crisis management will have on the financial landscape. The keynote speakers and panellists have given wide-ranging and, in some cases, diverging answers to that question. I am pleased to conclude this year's summit by offering my views on some particular aspects of the issues discussed today.

2. Future of the European Monetary Union

Let me start with the topic of the first panel this morning: the future of European Monetary Union. The crisis has highlighted shortcomings in the Union's institutional framework. Let me remind you of three serious flaws.

First, the deficit rules of the Stability and Growth Pact were not only circumvented by some member states, but deliberately bent.

Second, member states' borrowing was not effectively curbed because financial markets failed to exert a disciplining effect on public budgets.

Third, contagion effects transmitted via member states' financial systems were largely underestimated. The introduction of the single currency led to a greater integration of European financial markets. The highly integrated market increased the probability of contagion effects occurring via member states' financial systems. Hence, it amplified the existing close link between risks stemming from a country's public finances and the state of its banking system.

These flaws were a major factor in the emergence of the sovereign debt crisis and that fact makes a good case for strengthening the institutional framework of the monetary union. I welcome the measures that have been initiated. The reform of the Stability and Growth Pact and the agreement on the Fiscal Compact are major steps towards sounder budgetary policies. With the agreement on a European banking union, we have made further progress in one important specific area.

A banking union can help to strengthen financial stability by loosening the nexus between banks and sovereigns. A European banking supervisor would benefit from the ability to make cross-border comparisons, for instance. Such a body should be able to monitor the build-up of excessive risks and pinpoint them more easily and at an earlier stage. A single supervisory mechanism should also overcome the national bias of supervisors.

But a single supervisory mechanism is not sufficient. To shield banks from weak public finances, it must be accompanied by a sound regulatory underpinning. Such regulation should include upper limits for lending to governments and appropriate capital backing for sovereign bonds. Finally, a banking union should comprise a European resolution and

recovery mechanism to ensure that bank creditors – and not taxpayers – are the first in line to bear losses from a bank's failure.

Such a comprehensive banking union will be an important element of the new institutional framework of the monetary union. It will bring about significant changes not only for banks and their stakeholders, but also for regulators and supervisors with functions being transferred from the national to the European level.

3. Financial sector reforms

Changes will also be made through financial sector reforms. The financial crisis has highlighted weaknesses in financial sector regulation. As a response to this, the G20 Heads of State or Government set in train a comprehensive reform agenda in November 2008.

In the meantime, we have passed a number of major milestones on that agenda. But to make the international financial system as resilient and robust as it should be, we still have a long way to go.

One of the most pressing issues is the implementation of Basel III. What is most worrying is that doubts about implementation have been voiced with respect to countries that are home to global financial centres and systemically important institutions. I consider it of utmost importance that all G20 countries live up to their self-commitment of leading by example. The initial implementation timelines have been modified in the EU and the US. We need to make sure that such delays do not lead to a watering down of the measures that we agreed upon internationally.

Stricter banking regulation might set incentives to move business to less regulated entities. The regulation of the shadow banking system is therefore another pressing issue. Regular monitoring exercises help us to gain a better understanding of the kind and scale of business conducted outside the regulated banking system. But its actors and activities still remain largely unregulated. I consider it particularly important to deliver a final set of integrated recommendations on regulating the shadow banking system to the G20 in September.

And it is absolutely crucial to finally solve the too-big-to-fail problem. However, we have to keep in mind that this term is not very precise. In many cases, institutions were not too big but actually too important to fail. Recent examples of nationalisations and repeated bail-outs of institutions in the Netherlands and France show that, ultimately, it is still the taxpayer who is at risk when banks are in trouble. We need to remove the implicit government subsidy for systemically important institutions and subject them to the ultimate sanction of the market. It must be possible to force banks to exit the market without destabilising the financial system. To make this threat credible, we have to restore a constitutive element of any functioning market economy: the principle of liability. The one who profits must also be the one to bear the losses. I consider the implementation of the internationally agreed framework for dealing with systemically important financial institutions as a top priority.

Similarly, a "too big to fail" issue – but this time in the truest sense of the word – can also occur if the banking sector is too large in relation to the economy as a whole. The cases of Iceland, Ireland and Cyprus are good examples of this. The banking system in Cyprus is currently about 7 times the size of national GDP. By way of comparison, an average banking system in the monetary union is 3.5 times the size of national GDP. This problem has also been fuelled by the Cypriot business model of providing a low-tax environment.

If the banking sector is too large, the national taxpayer will be unable to bear the costs. Consequently, European solidarity will be required to resolve the problems. This is comparable to the case of systemically important banks, which depend on the support of the taxpayer if the bank gets into difficulties.

This is why the problem of banking sectors that are "too big to fail" also needs to be addressed one way or another. This could be achieved by downsizing the banking sector, as agreed at the meeting of the Euro Group.

But let me get back to the current reform initiatives. They need to be fully and consistently implemented to enhance the resiliency of the financial sector. To ensure consistency, we need to focus even more on the systemic aspects of financial regulation. Regulatory measures must build upon each other and be interlocked to set consistent incentives. Otherwise, we run the risk of individual measures conflicting with each other. Such a lack of consistency might lessen the desired effects of the new regulations or even negate them entirely. Impact studies are an important tool in this context. To gauge the effects of new regulation, such studies should accompany all major reform projects.

To avoid regulatory arbitrage, we must take into account the cross-border effects of regulation. The global financial system needs global rules. Accordingly, we need to ensure that internationally agreed measures are transposed into national laws and regulations in a timely and consistent manner. I strongly support the in-depth implementation monitoring by the Financial Stability Board and by international standard-setting bodies as essential tools for maintaining implementation pressure.

Finally, the crisis has reminded us that containing systemic risk is vital for safeguarding financial stability. To mitigate and prevent systemic risks, macroprudential policy frameworks are being implemented in many countries, including Germany. Since the beginning of this year, the German Financial Stability Act has been in force. A Financial Stability Commission comprising representatives of the Bundesbank, the Federal Financial Supervisory Authority and the German Finance Ministry has been established. The Commission is in charge of designing consistent macroprudential policies and held its first meeting just yesterday. The institutional set-up is fairly advanced. Now, we need to deepen our understanding of the effects of macroprudential tools and operationalise their use.

4. Changes to the financial landscape

Although financial sector reforms are not yet complete, it is already possible to see the impact of new regulation on the financial landscape. Some banks have fallen off the list of global systemically important banks because they have simplified their structure, downsized or de-risked their operations. This also includes a German bank. Several banks are de-emphasising high-profile but risky capital market business that benefited employees more than shareholders and society as a whole. The modified business models should ultimately result in a more resilient and diversified sector with a more sustainable risk-return profile.

Further changes to banks' business models will be brought about by structural measures. Concerns about institutions' business conduct built the political case for such measures, including the ring-fencing or prohibition of certain activities. Corresponding recommendations have been made by Paul Volcker, John Vickers and Erkki Liikanen in the US, the UK, and the EU respectively. While the proposals differ in important details, they share the same general idea. Deposit-taking credit institutions should be shielded from the risks of speculative proprietary trading and high-risk lending. Such a separation of business lines can play a part in making the financial system more stable and resilient. But it is not a silver bullet. Ultimately, we should leave it to bank boards and management to decide what business model is best for the future. I appreciate that the German legislative proposal on introducing a ring-fence leaves some leeway in that regard.

Finally, there is evidence that the corporate culture of banks is changing. Risk management, for example, has gained a more prominent role in the organisational structure of some banks. Efforts to strengthen risk governance have been undertaken as well, but further improvements are necessary. The manipulation of benchmark interest rates by traders is a case in point. Withholding or clawing back variable parts of remuneration packages of employees who were involved in such fraudulent activities can only be a first step. In the future, I expect to see further changes in institutions towards the promotion of sounder risk cultures.