Jens Weidmann: Challenges for banking regulation and supervision in the monetary union

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Deutscher Sparkassentag 2013, Dresden, 24 April 2013.

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1. Introduction

Mr Fahrenschon

Mr Genscher

Mr Steinbrück

Ladies and Gentlemen

It gives me great pleasure to speak to you today at the Sparkassentag 2013.

For more than three years now, the financial, economic and sovereign debt crisis has been the dominant topic in the European monetary union and, at the same time, its biggest test. Dated from the outbreak of the crisis on the US real estate market in the summer of 2007, this is already the fifth year in which we have been in crisis mode.

That said, Germany is still in relatively good shape – despite undergoing by far its worst post-war slump in 2009 and despite being one of the first countries to be affected by the spillover from the crisis on the US real estate market.

Germany has had to use considerable financial resources to stabilise the financial system. Savings banks, too, felt the effects of the crisis – although they did so directly only in a few cases; mostly it was through their investments.

Even so, savings banks had a stabilising effect during the crisis. They were a robust and reliable source of lending. And they strengthened their capital base. That is a major precondition for overcoming the challenges that are on the horizon – such as sustained pressure on margins and increased risk provisioning for the next economic downturn, which is bound to come at some time.

The various aspects of the crisis – first, only a financial crisis, then an economic crisis and, finally, the sovereign debt crisis – which is still with us – have prompted a large number of discussions, changes and upheavals. This applies to the role of central banks and to the expectation of what central banks can and should – or cannot and should not – do to help resolve the crisis.

It also applies to the financial system and the way it is perceived by the public at large. Mr Steinbrück will undoubtedly explain in more detail soon how he wishes to “tame the financial markets”.

Overcoming the crisis requires considerable efforts in many areas. But, as important as the issues of government debt, monetary policy and competitiveness are, I would now like to turn my attention to banking regulation and supervision.

2. Reform of financial market regulation – objectives and measures

Roughly ten years ago, the principal issue in banking regulation was Basel II and the regulatory changes it brought about.

At the time, only very few of those involved could have guessed that, just a short while later, the political agenda would be dominated by probably the most all-encompassing changes ever to the regulatory framework of the financial markets in the shape of Basel III and further

regulatory initiatives – and all starting off with an awe-inspiring zeal for reform. Basel II took five years from the first consultation paper up to a policy agreement on the new principles. Basel III only needed one year for that.

The new regulatory measures, which are designed to have a longer-term impact, are focused less on the acute management of the crisis and are geared more to preventing new crises from emerging in the future in the first place.

The changes initiated since the G20 meeting in Washington in November 2008, have the key objective of making financial systems more stable and therefore more resistant to shocks. Furthermore, the aim is that the taxpayer no longer has to step in to correct difficulties in the financial system. And it was also imperative to ensure that the financial system has a clear value added for the economy as a whole.

There is good empirical evidence that growth in the financial sector also strengthens a country's overall economic growth. On the other hand, studies by the IMF indicate that, along with increasing financial sector growth, this effect becomes weaker and might even go into reverse.

It is not necessary to agree with Paul Volcker's deliberately provocatively worded opinion that there hasn't been a useful innovation in the financial industry since the invention of the ATM, and derivatives do not have to be regarded as financial weapons of mass destruction. Nevertheless, if the financial sector is too large, there is evidently an increase in the risks to stability and the percentage of less beneficial transactions.

Cyprus is undoubtedly a telling example and provides an urgent warning that the supervisory and regulatory requirements have to keep pace with the size of the financial system relative to economic power.

A stable and efficient financial system that enhances growth and prosperity can be achieved only with a whole package of measures. With this in mind, the G20, at their meeting in Washington at the end of 2008, defined various fields in which there was a particular need for action.

Let me outline a few major points.

- Risks and mutual interdependencies in the financial system have to be more transparent.
- Banks should hold more and higher-quality capital so as to better shoulder losses themselves.
- Systemically important financial institutions – the hubs of the financial system – must meet special, stricter requirements, for example, with regard to capital adequacy and risk management.
- In the event of difficulties, it must also be possible to resolve or restructure large, international and particularly interconnected banks.
- Areas of the financial system which have hitherto been subject to no – or very little – regulation, but which perform tasks similar to those of banks and are linked directly or indirectly to the banking system, should be better regulated – the shadow banking system and derivatives trading are key issues here.

At this point, I would like to refer to a fundamental point that is particularly important to me. The connecting link between the stated aims and the means of achieving them is a strengthening of the principle of liability.

In his Principles of Economic Policy, Walter Eucken declared the principle of liability to be a constituent principle of the market economy, referring to the established legal principle that "those who benefit should also bear the costs".

Ensuring that players in the financial system have to, and are able to, better bear losses and risks themselves in future will make the financial system more stable and more focused on transactions that are beneficial to the economy as a whole and make the taxpayer the last rather than the first line of defence again in the event of crises.

Liability is therefore a step towards overcoming the crisis and not a negative concept – quite the opposite! It is the counterpart of the freedom to take decisions as an entrepreneur or investor in a self-determined manner. Freedom of choice and liability therefore belong together as a conceptual pair or two sides of the same coin.

That applies incidentally to the financial system just like it does to the member states within the monetary union. Some of the measures taken during the crisis undermine the principle of liability rather than strengthening it. It is against that background that we should also assess the newly resurfaced debate in Europe on the right course in fiscal policy.

Of course, a major role is played by the political acceptability of the reform course that has been embarked on. At least with regard to the programme countries, however, more time also means greater recourse to European solidarity: more funds are needed from the rescue package or maybe even transfers that have to be accepted politically by the "donor countries".

The non-programme countries, in turn, should not repeat the mistakes of 2004 and not interpret the strengthened Stability Pact too flexibly when it is first put to the test. France, in particular, has an important role in setting an example in terms of the credibility of the rules and confidence in the sustainability of public finances.

But back to regulation. At times, concerns are raised or the criticism is made that the implementation of these noble intentions is not making much headway and that enthusiasm for reform has waned significantly.

I can quite understand a certain amount of impatience. For example, with regard to the shadow banking system, an total integrated package with recommendations on regulation will not be ready until September and it will be even longer before concrete decisions have been made and enshrined in law.

The reform objective of clearing all standardised OTC derivatives through central counterparties and recording them by the end of 2012 has not been achieved. There are still several sticking points – starting with a lack of standards and ranging as far as data protection problems, and, in particular, the impasse in negotiations on cross-border coordination between the United States and Europe.

Progress has also been mixed on the "too big to fail" issue – more specifically the implementation of internationally agreed standards for resolution regimes. Here we have to contend with a certain tendency toward national protection and the fragmentation of the financial markets. Otherwise there is the threat of competitive distortions and new risks to stability. Just recently, Börsenzeitung gave a categorical and lucid warning against a new nationalism on the part of the supervisors. The US proposals on regulating the capital and liquidity of foreign institutions are a prime negative example of this.

A great deal therefore still needs to be done and we have to maintain political interest in a stable financial system.

Regulation is not an end in itself, however. The costs and benefits of the planned measures, including their side-effects and interactions, have to be weighed up against one another. This type of analysis is time-consuming and input-intensive, especially since the particular given country-specific aspects also have to be taken into consideration when the measures are actually implemented. And many of the implications are not immediately obvious, but still have the potential to be highly charged.

One example of this is the planned financial transaction tax and its implications for monetary policy. While a fundamental consensus has been achieved on the introduction of the tax, the

unintended side-effects might be considerable. In its currently envisaged form, the tax would also cover collateralised money market transactions, known as repo transactions, and would cause considerable harm to the repo market. The repo market plays a key role in the redistribution of liquidity among commercial banks, however.

If the market is not able to function properly, the relevant transactions will be shifted to the Eurosystem and central banks will remain heavily involved in the redistribution of liquidity among banks long after the crisis is over.

From a monetary policy standpoint, therefore, a very critical view has to be taken of the financial transaction tax in its current form, and this shows how important it is to scrutinise regulatory measures before they are introduced. But, again, that takes time.

However, this does not mean that regulatory reform has been a complete failure, because a whole series of measures is now in place with which the principle of liability is being strengthened. Let me just mention the example of stricter capital requirements in the form of Basel II.5 and Basel III.

At the end of February this year, political agreement was reached in the European Union concerning the implementation of Basel III through the Capital Requirements Directive IV and the Capital Requirements Regulation. The European Parliament also gave the draft legislation its seal of approval just last week. It may seem ambitious, but implementation of Basel III will therefore be possible in Europe from the beginning of 2014. Basel III will take full effect in 2019. Banks are using the interim period to raise their capital to the required level.

In the case of credit growth, however, there is the opposite fear is that the reforms are proving too successful. Deleveraging is still urgently required to overcome the crisis. However, this deleveraging process is also a contributory factor in the low growth rates for lending in some European countries. Developments in lending therefore reflect a necessary correction and are not in themselves an indication of the need for further economic policy action.

Incidentally, the cost-benefit analyses conducted before the adoption of Basel III show that these measures will, at most, have a very limited impact in terms of dampening economic growth. Sadly, however, there are still those in the banking industry – especially in the United States, but also in Europe – who are campaigning against the introduction of higher capital requirements.

In a recently published book, Bonn-based economist Martin Hellwig examined the arguments which are advanced in this context. According to Mr Hellwig and his co-author, there is no simpler and more cost-effective approach to crisis prevention than reducing large banks' dependency on borrowed money – in other words, increasing their capital requirements.

At the same time, it is also true that the large number of different regulatory initiatives makes it difficult to maintain an overview and evaluate the consequences. Acting on the principle that it is better to be thorough than hasty, it would therefore be necessary to estimate the overall impact of the regulatory agenda and evaluate it in a cost-benefit analysis.

Above and beyond all these regulatory reforms, Europe has another top priority on its agenda – the banking union and the organisation of banking supervision.

3. Banking supervision – on the road to a European banking union

The crisis has highlighted the need for a general overhaul of the financial market architecture of monetary union.

The banking union is closing an open flank that was already identified but not closed when the currency union was set up. If done properly, the banking union can actually counteract the risks of contagion risks stemming from difficulties in national financial systems.

In concrete terms, the banking union must have two pillars – a single supervision and a single resolution and restructuring mechanism. The SSM (single supervisory mechanism) and SRM (single resolution mechanism) are two more ingredients to the alphabet soup that is European crisis policy, but, in my opinion, they are two very important ingredients.

Creating a banking union involves a large amount of institutional construction work. Preparation of the relevant legal groundwork is in full swing at EU level for both pillars. In all likelihood, the single supervisory mechanism at least will be able to commence operation in the second half of 2014.

3.1 Single supervisory mechanism (SSM) under the ECB

The aim of the single supervisory mechanism (SSM) is to ensure that the same high standard of supervision applies throughout Europe, thus consistently containing excessive risks. It aims to make developments and risks in national banking systems more transparent and prevent domestic problems being glossed over. It will also be better able to monitor cross-border interactions than the sum total of national supervisors.

The SSM will not only supervise the most important banks directly. Not just the bank's absolute size or cross-border activities are of relevance, but also its significance for the respective economy.

The three most important banks of each member state will therefore be among the institutions which are supervised directly, irrespective of their absolute size. In total, some 130 banks throughout Europe will therefore be under the direct supervision of the SSM.

The SSM is to be placed under the auspices of the ECB. The Bundesbank is unhappy with this arrangement, as it gives rise to potential conflicts of interest between monetary policy and supervision on the Governing Council. As Klaas Knot put it, "letting banking supervision get started within the ECB so that it at least gets off the ground." However, I very much hope that this solution is not the final stage of development and that, in the medium term at least, the EU treaties will be amended to ensure a clear separation of monetary policy and supervisory responsibilities.

In terms of the distribution of responsibilities within Germany, it is crucial that the Bundesbank remain firmly involved in banking supervision so that we can share our extensive expertise and utilise the findings from supervisory activities for other tasks. This is even more important since the Bundesbank recently took on an even more significant role in the monitoring of financial stability in Germany through the Financial Stability Committee.

In this context, we are also keeping a watchful eye on the situation in the real estate market, which is no doubt a topic in your discussions, too.

For one thing, the crisis has once again underlined the risk of exaggerations on the real estate market. A recent Bundesbank discussion paper[1] even concludes that the "Great Recession" of 2008/2009 and the weak recovery that followed were largely due to problems in the real estate sector and, moreover, that negative shocks on the real estate market have a more significant impact on the real economy than positive shocks.

For another, there has been a marked rise in real estate prices in Germany recently – by around seven per cent in major cities in the last two years, for example. However, the Bundesbank does not currently perceive any credit-driven bubble.

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[1] Prieto, Eickmeier, Marcellino (2013): Time Variation in Macro-Financial Linkages, Bundesbank Discussion Paper 13/2013.

3.2 Resolution mechanism

To achieve its full potential, the single supervisory mechanism needs to be augmented by a single resolution mechanism (SRM). As in the case of the SSM, a solution that satisfies the requirements of European law ultimately calls for an amendment of the EU treaties. This has been quite rightly been emphasised by Federal Minister of Finance.

Essentially, the SRM is an important embodiment of the principle of liability. After all, liability also means that, in case of doubt, it should be possible to resolve banks without significant economic harm to the economy as a whole – and to see this through if the worst comes to the worst.

Resolving and closing a bank is by no means a cure-all and it is certainly not an easy task. Where possible, things should not be allowed to go that far in the first place. And that is where strict capital requirements, effective supervision and deposit business shielded from riskier business lines come into play.

The banking union also needs to be supported by an appropriate regulatory structure. In other words, banks must be required to hold sufficient capital for claims on government and not be allowed to accumulate them on too large a scale in future. It would be dishonest to assert that all these measures will make it impossible for banks to get into difficulties in the future. Therefore, if that actually does happen at some time, having a reliable procedure in place that creates planning certainty will be all the more important.

With this in mind, the main task of the single resolution mechanism that is currently being developed is to ensure the correct sequence of liability is applied in such a process. If a bank is to be restructured or resolved, equity investors should be the first port of call, followed by the providers of debt capital, and only then the depositors, taking due account of deposit guarantees in the respective member states. National and European taxpayers should only be called upon as a very last resort.

If public funds are used, the question arises as to how liability is to be apportioned between the European level and the member states. Joint liability of all member states can only exist at EU level for those institutions directly supervised by the SSM. In such a case, it is also appropriate, however.

Having said that, it is unclear whether the member states are to be discharged of all liability or whether a certain percentage of the costs is still to be apportioned to them. The latter is suggested by fact that, in the current framework of monetary union, member states are still able to exert a perceptible influence on financial stability through their national economic and financial policies – say, encouraging the emergence of a real estate bubble through special tax benefits.

This should be kept separate from the treatment of balance-sheet burdens that arose while the various banking systems were still under national supervision. If the unity of liability and control is also taken seriously on this point, too, the member states in question should themselves also be liable for these burdens as well. As the case of Spain shows, the ESM is ready to step in if raising the necessary funds on the capital market proves difficult.

Ultimately, what to do with legacy debts is a supervisory problem, not a question that has to be answered by politicians. If politicians actually do decide to communitise legacy debts, it will be nothing other than a financial transfer. Transparency for members of the general public and taxpayers then also requires that this transfer be disclosed as such.

The single resolution mechanism reduces uncertainty and mitigates the risk of contagion effects. The discretionary approach taken in the case of Cyprus is therefore not a blueprint for similar situations that may arise in other countries.

Events in Cyprus have shown that a bail-in is possible. But they have also highlighted the importance of establishing a clear sequence of liability and an orderly procedure, especially if turbulence due to depositor uncertainty is to be avoided. After all, the debate on to the extent

of depositor involvement has caused major uncertainty – in other countries, too. This was all the more the case as there was discussion about the possibility of using deposits that were actually protected by the Cypriot deposit guarantee scheme.

In connection with the security of customer deposits at banks, the question of whether a banking union should not include a single Europe-wide deposit guarantee scheme is also regularly under of discussion. The German Savings Bank and Giro Association has repeatedly expressed its very critical stance regarding a single European deposit guarantee scheme. And, indeed, it is important not to put the cart before the horse in tackling such projects.

Given the current degree of integration among member states and financial systems, a single Europe-wide deposit guarantee scheme would not be practical. Even more than is the case for the costs of resolution and restructuring, it is true to say that bank balance sheets reflect economic developments in the individual member states that are currently beyond European control.

Otherwise, taxpayers who are not involved would be made liable for mistakes in other countries without being responsible for those mistakes. It is much more important to set up the single supervisory mechanism and single resolution mechanism and put them on a firm footing.

4. Conclusion

In summarising my thoughts, I would like to stress that, yes, reforming financial market regulation is still a major task, but it is making headway, both in Europe and internationally. This means that, step by step, we are approaching the goal of bringing about an overall reduction in the risks to individual economies and the monetary union which stem from the financial systems without undermining their efficiency.

A key task in designing specific reforms is to give a more scope again to the principle of liability. The Bundesbank is diligently pursuing this aim by bringing its expertise to bear and, if it is necessary, is in for the long haul. Thank you for your attention.