Jens Weidmann: Making the financial system more resilient

Keynote speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the 2013 FESE (Federation of European Securities Exchanges) Convention, Berlin, 27 June 2013.

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1. Introduction

President Jochumsen

Ladies and gentlemen

Thank you for having me here today at this year's FESE Convention. It is the first time I have attended this event, although there are numerous points of contact between securities exchanges and central banks.

Central banks and securities exchanges have in common that they provide the economy with an infrastructure which is essential for a well-functioning market economy. Exchanges provide functioning and regulated platforms for the trading of securities, and so contribute to an efficient allocation of capital and resources. Central banks maintain price stability, thereby among other things also contributing to allocation efficiency and laying the foundation for sustainable growth.

Another important task of central banks is to smooth the operation of payment systems. The Eurosystem provides important infrastructure for the financial system, in particular TARGET2. By establishing TARGET2-Securities the Eurosystem will also provide a harmonised and centralised method of settling securities in central bank money in Europe that will improve settlement efficiency.

2. The role of financial market regulation

Some years ago, financial integration in Europe was considered a one-way street leading to greater wealth. This view has been challenged by the financial crisis, since it has shown the flip-side of financial integration in Europe, which is mutual contagion. In order to reap the benefits of financial integration without having the downside risk of contagion effects, micro-prudential regulation needs tightening and effective macro-prudential regulation has to be established.

More generally, the crisis has also challenged the formerly wide-spread view that the outcome of financial deregulation is always good. Adair Turner, the former Chairman of the British FSA, self-critically confessed in a speech he gave at Cass Business School in 2010: "We were philosophically inclined to accept that if innovation created new markets and products that must be beneficial, and that if regulation stymied innovation that must be bad."

I definitely do not want to deny the merits of innovative, flexible financial markets. But with hindsight, I think it is also hard to deny that insufficient financial market regulation as well as inadequate oversight and supervision helped macroeconomic and financial imbalances to emerge or to intensify. Moreover, differences in the speed and scope of financial deregulation at the national or regional level led to regulatory arbitrage by financial market players.

The pendulum has been swinging back since the onset of the financial crisis. When the leaders of the G20 pledged in November 2008 "to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight", this was the starting shot for a comprehensive global regulatory reform agenda.

Almost five years later, a great deal has been done. Many issues have been tackled and reforms have already been implemented. Yet a great deal still needs to be done and we have to maintain political interest in a stable financial system with appropriate regulation.

The key objective of financial regulation should be to make the financial system more stable and therefore more resistant to shocks. On the other hand, regulation must maintain the financial system's ability to fulfil its servicing role for the real economy appropriately.

In this regard, I agree with Robert Shiller, who believes in the value added of the financial system. In his most recent book he writes: "Finance, despite its flaws and excesses, is a force that potentially can help us to create a better, more prosperous and more equitable society." Hence, financial regulation is about addressing market failure and not about abolishing the market mechanism.

3. Strengthening the principle of liability

In order to achieve the key objective of a more stable and shock-resistant financial system, it is essential to strengthen the principle of individual responsibility and of liability.

The principle of liability is one of the basic principles for the functioning of market economies, and it should clearly also apply to the financial system. Essentially, it says that those who have the benefit should also bear the costs.

One of the root causes of the financial crisis is that, in the financial sector, the principle of liability was too weakly implemented. However, lacking liability creates incentives to take excessive risks. The problem of banks that are "too big to fail" may illustrate this. Ultimately, systemic importance infringes the principle of liability. Excessively risky transactions go unpunished because those who have the benefit do not bear the costs.

The decisive question now is how the principle of liability could be strengthened by regulatory measures.

- In the case of banks, higher capital requirements are the favourable and chosen way. They enable banks to shoulder greater losses by themselves, and thus shift the risk back to the owners. The implementation of Basel III – not only in Europe but hopefully in the United States, too – is therefore an important step towards making the financial system safer.

  In addition to the implementation of Basel III, I am convinced that it would make the banking sector less vulnerable and, thus, strengthen its liability if banks were required to hold sufficient capital for claims on sovereigns and not be allowed to accumulate them on too large a scale in future.

- The principle of liability is also important with regard to the establishment of a European banking union, which is currently the subject of heated debate.

  The main task of the single resolution mechanism that is currently being developed is to ensure the correct sequence of liability. If a bank is to be restructured or resolved, equity investors should be called on first to take losses, followed by the providers of debt capital and only then by depositors, taking due account of deposit guarantees in the respective member states and national or European rescue funds. Taxpayers should only be called upon as a very last resort.

  While joint liability implies joint control, the other way round is also true. However, even after the creation of a banking union, banks' balance sheets also remain a mirror of national economic and legal developments. Changes in national insolvency law i.e. would have an impact on the burden possibly to be financed by European funds. Hence, the banking union needs far-reaching coordination and tighter joint regulation. Remaining room for manoeuvre in regulation at national level has to be considered when deciding on the distribution of the financial burden between the

member states. Legacy risks, however, should not be related to the banking union. If it is actually decided to communitise legacy debts, this would be a financial transfer. Transparency for members of the general public and taxpayers then also requires that this transfer be disclosed as such. Of course, transfers are usually not reinforcing the liability principle.

It goes without saying that strengthening the liability principle goes beyond bank regulation. Regulatory measures in other fields of the financial system have to make sure that non-bank financial entities become more liable and accountable, too.

Let me give you two examples

In future, credit rating agencies will be held liable in the event of intentional or grossly negligent violations of the respective European regulation. I appreciate this, but it is clear that it will be difficult to prove deliberate intent or gross negligence in practice.

However, while making credit rating agencies more liable and accountable helps to improve the quality and integrity of credit ratings, it is not sufficient to ensure proper risk management in the financial system. In order to improve due diligence, it will also be required – as intended by the new EU regulation CRA III – to reduce the mechanistic reference to external credit ratings in financial market regulation, which has led to an overreliance on external ratings.

Although external ratings will still have a role to play in financial markets, investors should become better able to conduct their own risk assessment, and so become more responsible for their investment decisions. After all, a rating is no substitute for thought.

Another case that could be seen as an example of regulators' commitment to increase the liability of all market participants is the reform of OTC derivatives markets.

Much progress has already been made by requiring sufficient collateralisation for derivatives positions, especially when cleared centrally through central counterparties. In other words, market participants will be forced to bear further costs of their derivatives business in the near future. The clearing obligation will be complemented by a trading obligation for eligible OTC derivatives.

Last week EU finance ministers agreed on a common position regarding a revision of MiFID (Markets in Financial Instruments Directive) which will have a significant impact on European exchanges and other trading venues. The MiFID review will shift a significant share of OTC derivatives trading to exchanges or other regulated trading venues. Light will be shone on dark trading by trade transparency requirements, leading to more accountability for derivatives traders.

4. Beware the risk of government failure

The basic task of financial regulation is to cure market failure. The large number of regulatory work strands might create the impression that the, at times, exaggerated faith in the efficiency of the markets before the crisis is now being replaced by excessive faith in governments. The financial crisis, however, is not only the result of market failure. To some extent, it is also the result of government failure and undue regulation.

Just think about how public incentives for home ownership helped housing bubbles in various countries to emerge or how the zero-risk weighting of sovereign bonds gave incentives to over-invest in sovereigns. Hence, regulators should refrain from substituting and fine-tuning markets and private agents.

We should bear in mind what Walter Eucken, one of the founding fathers of German ordoliberalism, once wrote, namely that economic policy should aim at "the shaping of the forms of order of an economy" and "not the direction of economic process".

Regulation is not an end in itself. The costs and benefits of the planned measures, including their side-effects and interactions, have to be weighed up. One example of this is the planned financial transaction tax. While a fundamental political consensus has been reached on the introduction of the tax in some countries of the EU, the unintended side-effects have to be considered carefully.

In its originally envisaged form, the tax would also cover collateralised money market transactions, known as repo transactions. This would cause considerable harm to the repo market, which plays a key role in the redistribution of liquidity among commercial banks. However, hampering it would make banks more dependent on liquidity provision by central banks.

5. Conclusion

To sum up, over the past five years, substantial progress has been made in the regulation of the financial system. Nevertheless, there is no room for complacency. There are still shortcomings in financial regulation to be eliminated.

This notwithstanding, it is necessary to thoroughly assess the impact of the different reforms and measures.

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. Strengthening the principle of liability will help the financial system to serve the economy and society better.

Thank you for your attention.