# Andreas Dombret: Striving to achieve stability – regulations and markets in the light of the crisis

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Ifo Institute Munich Seminar, Munich, 27 January 2014.

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## 1. Introduction

Dear Mr Sinn,

dear Franz-Christoph Zeitler,

Ladies and Gentlemen,

I am delighted to have been invited to speak to you at today's Ifo Institute Munich Seminar.

Notwithstanding Mr Sinn's presence, I shall not be mentioning TARGET2 balances, although they certainly represent an important topic, with plenty of scope for discussion. Instead, I shall devote my attention to a subject with which economists have already been preoccupied for quite some time. In fact, they have been jostling with it for so long that it has given birth to a whole raft of jokes.

Strangely enough, most of these jokes revolve around the question of how many economists are needed to change a light bulb, the standard answer being: none, on the grounds that if the bulb in question really needed changing, the market would have long since attended to the matter. An alternative answer is that the bulb would have replaced itself – if only the government would let it.

As you may have guessed, my subject today is the relationship between the market and the state, a topic which is consistently raised in the aftermath of a crisis. And, needless to say, we've had plenty of crises to contend with in the last few years.

On 15 September 2008, the US investment bank Lehman Brothers filed for bankruptcy. This ushered in a worldwide financial crisis and a global recession, both of which have greatly burdened the public purse while destroying jobs and diminishing our wealth. In particular, it undermined the confidence of the general public in the market.

On 10 May 2010, the euro-area member states decided to provide Greece with financial assistance. This event marked the "official" onset of the sovereign debt crisis in the euro area, a crisis which has also eaten into taxpayers' money while eliminating jobs and reducing prosperity. It has also impaired people's trust in their governments, especially in the state's ability to manage its finances competently and overcome crises.

This almost simultaneous draining of confidence in the market and in the state is of singular importance for it obstructs the usual reflex reactions after a crisis: to demand either more state intervention or, alternatively, an enhanced emphasis on market forces.

However, in my view, these calls for more of the former or more of the latter are in any case often misguided. Periods of deregulation, ie more of the market, often culminate in a crisis. By the same token, periods of reregulation, ie more of the state, often lead to economic stagnation. This amounts to a choice between overheating on the hand and ossification on the other.

Poorly considered instinctive reactions are thus likely to take us down the wrong path. It is precisely for this reason that we should regard the simultaneous loss of confidence in the market and state as an opportunity to be grasped. An opportunity to move forward in our efforts to achieve stability.

## 2. More market orientation in the financial market

Financial stability is not a matter of choosing between the market and the state. Rather, it is a case of finding the right relationship between the two. Here, we can turn to the tried and tested principle of letting governments lay down the regulations while the market is allowed to function freely. The state defines the perimeter fence while the invisible hand of the market guides events on the playing field.

Upon first consideration this would seem to be a relatively simple construct. But is it really that straightforward in practice? Clearly, it is not. Especially with regard to the financial markets, the task is far from simple. There is a "grey area" in which the boundary between the market and the state becomes blurred. This grey area arises from the problem of systemic importance.

Participants in the financial sector are highly interconnected. These links start with the banks which lend money to one another and finish with complex derivative vehicles in which many players are involved. If a bank runs into trouble, this will also impact on all its counterparties. And if the bank in question is particularly large or has dealings with an especially large number of counterparties, its troubles can upset the balance of the entire financial system. We saw where this scenario led in 2008 when Lehman Brothers became insolvent.

In cases like these, the state may have no choice but to rescue the bank concerned in order to prevent an escalation of the crisis. Such rescue efforts are of course extremely costly; in 2010, Ireland was obliged to spend more than 30% of its annual economic output on supporting Irish banks. And these costs are ultimately borne by the taxpayer.

But this policy not only comes at a cost to the taxpayer; at a deeper level it also changes the structure of the financial system. Large, interconnected banks effectively enjoy insurance protection courtesy of the state. If they encounter distress they can depend on the state to bail them out as they are deemed too big – or too interconnected – to fail.

However, this implicit state insurance policy flies in the face of a fundamental principle of the market economy. A principle which Walter Eucken summarised in a single sentence: "Those who enjoy the benefits must also bear the costs." This liability principle is the bedrock of any functioning market economy. Once it is abandoned, economic agents change their behaviour, giving rise to moral hazard.

Such an environment incentivises large, interconnected banks to enter into high-risk transactions. If these transactions are a success, the bank will reap the benefits, however if the same transactions make a loss, it is the taxpayer who may ultimately suffer. Thus, large interconnected banks intrinsically pose a risk to financial stability. At the same time, this is precisely why they engage in such risk-taking in the first place – which all makes for a dangerous feedback loop.

This is where the boundary between market and state becomes blurred, thus generating the aforementioned grey area within which the standard division of responsibilities between market and state ceases to apply. The state's role is no longer confined to setting the rules, rather it becomes an active agent itself on the playing field. And this is the cause of the problems I have described.

So how can we redraw the boundary between market and state? We should start by looking at the problem of banks' systemic importance. This should also be the first point we seek to tackle.

The question we need to ask is: should banks be allowed to fail? My response is: of course banks should be allowed to fail. The possibility of market exit is a key element of any market economy. Business models that fail to succeed must make way for better business models.

However, with respect to systemically important banks, this principle does not apply. In reality, as Martin Hellwig described in his book "The Banker's New Clothes", and I quote: "The question of whether banks should be allowed to fail is, however, seldom raised as a basic starting principle." I have just elaborated on the reasons for this. So how we should go about re-establishing the possibility of failure for all banks, including systemically important ones, as a fundamental principle?

What we need are mechanisms that enable a bank to be wound up without causing the entire financial system to get into difficulties. Only then will banks be confronted with the real threat of a market exit and only then will it be possible to do away with the implicit state guarantee; only then will banks have an incentive to behave in a risk-aware manner.

Resolution mechanisms of the kind I describe are, however, complex to install, not least because large banks are usually multinational in nature. They frequently have dozens of affiliates spread across numerous countries. In order to be able to wind up such a bank, we need international cooperation based on a sound legal foundation. In this context, initial steps have already been taken at the international and the European level. Nevertheless, there is still a long way to go.

One question is particularly important when winding up a bank: who will pay for its resolution? Here, a clear hierarchy of responsibility must be established. The bank's owners and creditors have to be first in line when it comes to bearing the losses, with taxpayers at the bottom of the list. This is the only way to reinstate the principle of liability according to which those who enjoy the benefits also must bear the costs.

This "bail in" option will therefore be an important component of the Single Resolution Mechanism which is planned at the European level.This mechanism is intended as a key pillar of the banking union, and it is vital that it does indeed fulfil that role. In future, the shareholders and creditors of failing banks are to be the first in line to bear the resulting resolution costs, followed by a resolution fund financed by the banking sector. Bail-outs using public funds – and hence taxpayers' money – are to be a last resort.

In short, clearly defined bank resolution mechanisms will help us to address the problem of systemic importance. And they will therefore play a crucial role in redrawing the boundaries between the market and the state. Of course, this doesn't mean that we want as many banks as possible to fail.

## 3. More stability for the financial market

In a market economy, banks should fail if their business model is unsuccessful – if the problem therefore stems from the bank and its structures. Yet banks should not crumble under the force of each and every external shock – every economic downturn or burst asset price bubble – that they experience. Wherever possible, banks must be capable of weathering those kinds of storms.

In view of all this, I believe that two elements will be especially important in making banks more stable: capital and liquidity. Deficits in both of these things were factors which contributed significantly to the financial crisis. The state can bring in regulation to address these deficits, and has done so very successfully. Amending the capital and liquidity requirements was therefore very high on the international reform agenda right from the start.

And the new Basel III regime significantly raises capital requirements for banks. In future, banks will need to hold more – and better-quality – capital, and the requirements for systemically important financial institutions are stricter still. In addition, Basel III has introduced the very first international liquidity standard.

These rules will play a crucial role in safeguarding financial stability. However, there is still a weak link in the capital rules – as the euro-area crisis has clearly shown.

The need to bail out systemically important banks with taxpayers' money puts pressure on government budgets. That was one of the focal points of the first part of my speech here today, and I mentioned Ireland as a striking example. Yet problems can also flow in the opposite direction: shaky public finances can cause difficulties for banks. Greece is a case in point.

This kind of contagion is mainly caused by government bonds held on bank balance sheets. And many banks have large holdings of domestic government bonds, especially in the euro area. Take Italy and Spain, for example. Current figures show that Italian banks hold more than 10% of all bonds issued by the Italian public sector, and that Spanish banks hold almost 9% of Spanish public bonds.

Essentially, this is a vicious circle: a country's public finance problems spill over to domestic banks, while banks' woes place a strain on government budgets in the country where they are based. To better protect public finances, we need bank resolution mechanisms and the option of a "bail-in". But how can we shield banks most effectively from the impact of public finance problems?

These risks stem from government bonds held on bank balance sheets. And that is precisely where the problem needs to be tackled. Bank regulation treats government bonds comparatively generously. Usually, the higher the risk attached to a loan, the more capital a bank must hold against it. Yet this does not apply to lending to governments – and thus to government bonds. Bank regulation classifies them universally as risk-free.

Yet since the onset of the sovereign debt crisis, if not before, this treatment has no longer seemed justified, as it has become apparent that government bonds do carry some solvency risk. It would therefore be appropriate to change the rules in the medium term. We believe that government bonds, just like other loans, should be backed with sufficient capital to reflect the risks that they carry. At the same time, a ceiling could be imposed on lending to any one government, just as lending to other borrowers is subject to a limit of this kind. These two measures combined would shield banks from the impact of public finance problems.

By adjusting the rules, governments can help to make banks, and hence the financial system, more stable. However, rules are only effective in the areas where they apply. And there is one area of the financial system which is not yet truly regulated: the shadow banking system.

I have to confess that I don't really like the term "shadow banking", as it strikes me as slightly unfair. It makes the industry sound rather shady, or even criminal. And that certainly isn't the case. The shadow banking system contains entities which, like banks, perform credit intermediation. The difference is that these entities – such as US-style money market funds – don't belong to the regulated banking sector. Shadow banks are not bound by the normal "rules of play".

In terms of financial stability, the crux of the matter is that these entities can cause similar risks to banks but are not subject to bank regulation.And the shadow banking system can certainly generate systemic risks which pose a threat to the entire financial system.

Much the same applies to insurance companies. Although they aren't a direct component of the shadow banking system, they can also be a source of systemic risk. All of this makes it appropriate to extend the reach of regulation.

## 4. Conclusion

In conclusion, I would like to reiterate the three main points of my speech.

- First, we need to redraw the boundaries between the state and the market by tackling and solving the problem of systemically important banks.
- Second, the state needs to amend bank regulation – not least by requiring banks to hold capital against government bonds.

- And third, the state must extend the reach of regulation. The shadow banking system and insurance companies also warrant our attention – albeit for very different reasons.

These three aspects are crucial to ensuring financial stability, but they will not be sufficient on their own. We need to be clear about one thing – we cannot achieve financial stability through regulation alone. Government regulation sets a framework for the market, but all market participants have to behave responsibility within those confines. To paraphrase the Roman philosopher Seneca, decency may forbid what the law does not – and we cannot stress this principle often enough.

At the moment, there is reason to doubt whether all of our citizens truly believe that banks are capable of the kind of decency we need to see. The many unforgivable market manipulation scandals of recent years have further undermined public trust in the willingness of banks to behave responsibly. And that is a dire situation to be in, as bank business is largely based on trust. To lose that is to risk losing everything.

So this trust urgently needs to be restored. Stricter regulation can help in this process, but the banks themselves must also do their part to remedy the situation. They have to show that they are prepared to make changes that go above and beyond what the law requires. They must show that they are capable of pushing through the necessary change of culture in the banking industry.

It will be crucial for banks to behave in a manner which reflects what they really are: service providers for the real economy. Financial transactions are not an end in themselves. If we can instil this idea in people’s minds, we’ll be able to take the final key step in our quest for greater stability.

Thank you very much.