Andreas Dombret: Regulatory reform – unresolved issues and the need for international cooperation

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Harvard Law School Symposium on "Building the Financial System of the 21st Century – An Agenda for Europe and the United States", Armonk, New York, 28 March 2014.

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1 Introduction

Ladies and gentlemen

Thank you for the opportunity to speak today at the Harvard Law School Symposium on Building the Financial System of the 21st Century – An Agenda for Europe and the United States. It is a great pleasure to be here.

In November 2008, just a few weeks after Lehman Brothers failed, the leaders of the G20 met in Washington D.C. In their meeting they took far-reaching decisions – not only to combat the current crisis but also to prevent future crises. A central passage of their declaration was as follows: "We pledge 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, as appropriate to their circumstances."

Today, more than five years later, we have made good progress. Nevertheless, we must be aware of what Mark Roe from Harvard University calls the "regulatory confidence cycle". He writes: "Regulators react to an explosion by creating new rules. The economy recovers; the regulators conclude that they did their job well, and the regulated then resist further tightening. […] As the recovery continues and the memory of the financial crisis grows faint, the appetite for regulatory change dissipates. Why fix something that is no longer broken?".

On a superficial level it appears that the financial system has been mended. However, we have to ensure that it will not break again – and this is an objective we have not yet achieved. There are still issues we need to address in order to create a stable financial system. In my speech today, I would like to highlight three of these issues: the too-big-to-fail problem which has already been discussed this morning, the shadow banking system, and the market for OTC derivatives. Let us begin with the too-big-to-fail problem.

2 Taming the beast – the too-big-to-fail problem

Leaving aside all the nitty gritty, there is one thing we have to do to resolve the too-big-to-fail problem: we need to introduce more "market" to the financial markets – that is, we have to restore the fundamental principles of a market economy.

The most important of these principles is the principle of liability. Everywhere it is common sense that people should be held responsible for their actions. Everywhere but in the world of banking, it would appear. During the crisis, governments around the world spent billions of dollars out of taxpayers' pockets to save the banks. This indicates that the too-big-to-fail banks, at least, play by a different set of rules. They are woven so deeply into the fabric of the financial system that their failure might tear everything apart.

The consequence is this: whenever a too-big-to-fail bank runs into trouble, the government might be compelled to bail it out in order to prevent a full-blown financial crisis. This means that these banks are implicitly insured. Whatever happens, the government is likely to stand ready to help.

And this has consequences for the nature of the game. First, according to a recent study by the Federal Reserve Bank of New York, "too-big-to-fail" banks have a funding advantage

over smaller banks. Second, the implicit insurance provides incentives to engage in risky business that promises high returns. If things turn out well, the bank wins. If things go wrong, the taxpayers lose.

The principle of liability has obviously been violated. The crucial question at this juncture is the following: what do we need to do to restore it? Well, the decisive point is that banks must be able to fail without dragging the entire financial system down with them. What we need are effective resolution mechanisms for banks. This is common sense at the conceptual level. However, when it comes to implementation, things turn out to be a little more complex.

Putting practicable resolution procedures in place is a difficult endeavour, especially in the international context. Systemically important banks have large numbers of entities in many countries, each of which has its own procedures and supervisory traditions. In the absence of a sound legal basis and close cooperation, resolution measures executed in one country might not always be recognised by other countries.

Thus a well-coordinated approach between authorities is needed. The purpose is to maintain systemically important activities while resolution procedures are applied. Coordination and advanced planning of resolution measures enable authorities to consider financial stability from an international point of view, not merely from a national perspective. To this end, a new international standard on the recovery and resolution of systemically important institutions has been developed by the Financial Stability Board. Having this new standard is a big step forward.

At the European level, a central pillar of the envisaged banking union is the Single Resolution Mechanism. This instrument will allow authorities to restructure or resolve banks without putting taxpayers' money at stake. In the future, whenever a bank fails, resolution costs must be borne first by shareholders and creditors. After that, a bank-financed resolution fund is to come into play, and only as a last resort are public funds to be used and the taxpayers made to pay.

3 Bringing light to the shadows – the shadow banking system

We have made good progress at the global and the European level in addressing the too-big-to-fail problem. However, discussions have mainly centred around the banking system. Yet there are other parts of the financial system that might become a source of systemic risk. One of them is the shadow banking system.

According to the Financial Stability Board, the shadow banking system comprises "credit intermediation involving entities and activities outside the regular banking system". What I think is relevant from a financial stability perspective is that such entities create bank-like risk without being subject to bank regulation.

The overall effects of the shadow banking system on financial stability are ambiguous. Theoretically, non-banking financial institutions that perform bank-like activities are associated with diversification and specialisation benefits. Therefore, it could be assumed that they contribute to making the financial system more efficient and more resilient.

However, developments in the run-up to the financial crisis revealed something else: activities and entities in the shadow banking system can pose a threat to financial stability. These potential threats are mostly the result of maturity and liquidity transformation, the build-up of leverage and credit risk transfer conducted outside the perimeters of bank regulation.

All these activities are not evil per se, but the ensuing systemic risk needs to be contained. All activities must be made transparent, in particular vis-à-vis supervisory authorities, and they need to be adequately regulated. In that regard, I welcome the global regulatory initiative on shadow banking – again under the leadership of the Financial Stability Board.

And here too, international cooperation is essential for establishing effective regulation. A central feature of the shadow banking system is regulatory arbitrage: activities are shifted from the banking system to the shadow banking system in order to evade regulation. A geographically fragmented approach to regulation would not curb regulatory arbitrage but just take it to another level. Against this backdrop, it is to be welcomed that the G20 have placed the shadow banking system high up on their agenda.

4 Structuring the market – OTC derivatives and CCPs

The third issue I would like to raise relates to the structure of the market – the derivatives market, to be precise. Trading in derivatives certainly has the potential to cause massive losses, to disrupt markets and to threaten financial stability.

But it is not just during trading that financial stability can be put at risk; it can also be jeopardised at the back office level when transactions are cleared and settled. And this might pose a problem for all market participants, be they part of the banking system or the shadow banking system.

The G20's decision to require OTC derivatives to be cleared centrally was an important cornerstone in regulating OTC derivatives markets.

Central counterparties, or CCPs in short, are able to mitigate systemic risk and act as risk buffers in global financial markets. This appears particularly striking when we consider two sources of potentially huge losses: first, extremely one-sided derivatives positions and, second, the high degree of opacity surrounding the interconnectedness of global financial players. In this regard, CCPs will help to better solve another problem I already mentioned: the too-big-to-fail issue.

However, CCPs themselves are becoming more systemically important. This harbours potential side effects which need to be monitored. Furthermore, effective recovery and resolution regimes need to be in place for CCPs. To shield taxpayers' money, potential losses have to be distributed among clearing participants, which are often globally active banks. This gives rise to potential contagion risks and domino effects. Therefore, a careful calibration of recovery and resolution regimes is crucial.

Against this backdrop, international coordination is again essential. The regulation of OTC derivatives markets should be the same across all jurisdictions – in spirit, in wording, and in terms of its outcome. This would allow the corresponding national regulators to defer to each other's rules when cross-border transactions occur. Otherwise, regulatory arbitrage, market fragmentation and liquidity disruptions might be the consequences.

Some progress has been made over the past year towards resolving these cross-border issues. One example is the 'Path Forward', a joint statement which was agreed upon by the European Commission and the CFTC in July 2013. This statement is a necessary foundation for further cooperation. However, some cross-border matters are still unresolved and urgently need to be addressed.

Major differences between the US and EU regulations can be found, for instance, in the methods used to compute the initial margin coverage of CCPs. And they can also be found in the scope of reporting requirements to trade repositories. Let us take a brief look at these two examples.

First, the rules used for calculating the minimum initial margins of CCPs differ between the US and the EU. Generally speaking, CCPs ask for initial margins in order to hedge the market risk of a derivatives position during the liquidation period in case a clearing member defaults. Under the existing EU and US regulation, risk managers at CCPs have to take into account different minimum liquidation periods and confidence intervals when calculating adequate initial margins. As a result, the initial margins requested by CCPs may vary considerably, depending on the location of a CCP. This might eventually drive business

towards those CCPs with less strict initial margin calculation requirements. To prevent such regulatory arbitrage from happening, it might make sense to agree on consistent and strict international standards in detail and thus reduce national leeway.

Second, the mandatory reporting rules differ significantly in terms of timing and scope. In the US, only CFTC-registered "Swap Dealers" and "Major Swap Participants" are required to report their transactions to trade repositories in real time. In the EU, meanwhile, transactions have to be reported by the end of the next business day by both contracting parties. Furthermore, exchange traded derivatives, market prices and collateral levels have to be reported in the EU, but not in the US. It remains to be seen whether these differing reporting rules can be recognised as being equivalent. And – more importantly – it also remains to be seen how a meaningful and accurate global aggregation of trade repository data can be brought about.

5 Laying the groundwork – cooperation and harmonisation

Ladies and gentlemen, I have briefly discussed the too-big-to-fail problem, the shadow banking system and the market for OTC derivatives. Each of these issues highlights the need for international cooperation. If we do not coordinate our approaches towards regulation we will create a fragmented financial system. A financial system with vast opportunities for regulatory arbitrage and ample sources of systemic risk.

Against this backdrop, recent regulatory initiatives in the US worry me. They seem to contradict the need for international cooperation. A "Balkanisation" of the regulatory space represents a genuine risk, and any regulatory decision should be taken with that consideration in mind – in Europe as well as in the United States.

And this not only applies to regulation itself but also to the foundation on which it rests. Regulating and supervising financial institutions requires information. And to satisfy the need for international cooperation, this information has to be internationally comparable. Unfortunately, this is not always the case.

It is not an entirely new insight that differences in accounting standards across countries hamper the international comparability of balance sheet data. This in turn can potentially impede financial regulation. A prominent example is the treatment of derivatives and how this affects balance sheet ratios which are subject to regulation.

Derivatives netting rules under US GAAP allow US financial institutions to net their derivatives positions to a large extent. In Europe, the IFRS accounting rules are far more restrictive in this regard. That is why derivatives volumes appear to be much larger at European banks than at their US counterparts.

Going one step further, regulatory balance sheet ratios which relate to total assets differ between US and European banks. The leverage ratios of US banks, for instance, generally appear much lower than those of European banks. Hence, in this particular case, distortions arising from different accounting rules may make it easier for banks in the US to comply with a given regulatory leverage ratio than for their European peers.

So far, standard setters have only agreed to harmonise the information disclosed in the notes of financial statements. Nevertheless, global harmonisation of accounting standards is needed in order to create a regulatory level playing field and avoid regulatory arbitrage. In my view, this is certainly something that has to be moved higher up the agenda of global regulation.

6 Conclusion

Ladies and gentlemen, we have made good progress in adjusting financial regulation. Nevertheless, we have not reached our destination; regulatory reform has to continue. I have discussed some of the outstanding issues in my speech: too-big-to-fail banks, shadow

banking, OTC derivatives and accounting standards. I also highlighted the need for international cooperation.

At the beginning of my speech I cited a passage from the G20's Washington declaration. Let me close my speech by quoting another passage: "Our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability."

That is the spirit, ladies and gentlemen. To reach our destination – a stable financial system – we will have to walk together.

Thank you very much.