Andreas Dombret: Financial market regulation – standing still means falling behind

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 2014 Alternative Investor Conference of the Federal Association for Alternative Investments (Bundesverband Alternative Investments), Frankfurt am Main, 14 May 2014.

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1 Introduction

Ladies and gentlemen

Thank you very much for inviting me to speak at this year's Alternative Investor Conference – I am delighted to be here today.

My responsibilities at the Bundesbank have actually changed slightly since I accepted your invitation. As you may know, the Bundesbank appointed a new Deputy President, Professor Claudia Buch, yesterday, and the distribution of responsibilities within the Executive Board has now changed. After being the board member in charge of financial stability for four years, I was assigned responsibility for banking and financial supervision yesterday.

Ultimately, though, these two areas have the same overarching aim – they simply approach it from different angles. Their objective is to maintain a stable financial system. And the business of achieving this aim has not got any easier over the past few years.

Our world – and, not least, our economy – is becoming more and more interconnected. And a global economy can't function without a global financial system. This makes the financial system more important, yet it is ultimately still a means to an end – it is a service provider for the real economy.

In this role, the financial system – or, more precisely, its stability – is a public good. As economists like to put it, there are external factors at play. If the financial system is thrown off balance, this also has a negative impact on those outside it – businesses in the real economy or taxpayers, to name two examples.

That is why it is necessary to regulate the financial system in order to safeguard its stability. The need for regulation is beyond dispute: the question is not whether, but how we should regulate. Of course, there are a number of different ways to approach the issue, but one thing is clear: regulation isn't stationary. The financial system is in constant flux, and regulation has to keep pace with it.

Regulatory reform is usually triggered by a crisis – and the recent crisis is no exception. It set in motion a fundamental review and reform of financial market regulation. Work on this reform began at a global level in 2008, and it is still underway. Many important measures have been agreed, and some have already been implemented. Yet certain areas still need a lot more work. I would like to discuss two of these issues here today: the "too big to fail" problem and the shadow banking sector.

2 Still "too big to fail"?

The "too big to fail" problem was a key factor in the recent crisis, and it still isn't completely solved. But first let's take a look at the essence of this problem.

Participants in the financial system are highly interconnected. If a bank runs into trouble, this will also affect its counterparties. And if the bank in question is particularly large or has an especially high number of counterparties, its woes can destabilise the entire financial system.

We saw how devastating this scenario can be in 2008, when Lehman Brothers became insolvent.

In such cases, the state may have no option but to bail out the distressed bank in order to prevent an escalation of the crisis. Such bail-outs are, of course, extremely costly; in 2010, Ireland was obliged to spend more than 30% of its annual GDP on bail-outs for stricken Irish banks. And these costs are ultimately borne by none other than 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 and interconnected banks enjoy an implicit state guarantee. If they run into difficulties, they can always count on the state bailing them out – they are "too big", "too interconnected" or simply "too important" to fail.

This encourages large and interconnected banks to enter into high-risk transactions. If these transactions are successful, the bank will reap the benefits; if they make a loss, the taxpayer may ultimately have to foot the bill. Large and interconnected banks therefore 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.

So how can regulation help? One option would be to prevent large banks from becoming distressed in the first place. Notably, the new Basel III capital requirements are an important step in this process. But can they rule out bank failures altogether? And should we even try to do so?

My answer to both of those questions is a resounding "no". Of course we can't rule out bank failures entirely, and nor should we try. The possibility of a market exit is fundamental to any market economy. Failed business models must make way for better ones, in the process that Schumpeter famously described as "creative destruction".

What we need are mechanisms that allow even big banks to fail without destabilising the entire financial system. Only then will banks face the real threat of a market exit; only then will we eliminate their implicit state guarantee; and only then will banks have an incentive to be risk-aware in their actions.

Without these kinds of mechanisms, we cannot solve the "too big to fail" problem. And there is still a good deal left to be done, as the markets themselves acknowledge. Recent studies by the IMF and the OECD show that the markets still assume that, if push came to shove, the state would not let big banks go under. And it's true that there are two problems relating to credible resolution mechanisms which have yet to be resolved.

First, resolution mechanisms are inherently complex – especially those for big banks, which tend to operate globally. They often have dozens of branches spread across numerous countries. To be able to resolve a bank of this kind, we need international cooperation that is built on solid legal foundations. We have now taken some initial steps towards this goal – through the Financial Stability Board principles at an international level and the agreement to create a Single Resolution Mechanism at a European level. Even so, there is still a long road ahead of us.

Second, each bank resolution throws up the same question: who should bear the costs? When a bank is resolved, there have to be sufficient resources available to absorb losses. These resources – known as "gone concern loss absorbing capacity", or "GLAC" – should be sufficient to allow the failed bank to be resolved. In other words, GLAC should help to recapitalise viable components of the failed bank, or a bridge bank. The aim is to preserve the bank's critical functions while avoiding a government bailout or turmoil on the financial markets.

GLAC should become to the "gone concern" scenario what the Basel III regime is to the "going concern" scenario. And for both we need internationally binding minimum standards which are mutually compatible. The Basel III capital standards have already been approved, whereas a minimum standard for GLAC is currently under development.

3 Parallel banking – there is no light without shadow

Ladies and gentlemen, we haven't yet crossed the finishing line in our quest to solve the "too big to fail" problem. But that is not the only area which needs a lot more work. If we want to safeguard financial stability in future, regulators will need to set their sights beyond the banking system – to the shadow banking system.

But I have my reservations about the term "shadow banking system". The word "shadow" usually conjures up images of unsavoury, shady activities. And that is in no way a fair description of the shadow banking system.

Still, there's no denying that we have too little data on the shadow banking system, which means that we don't have quite as clear a picture of it as we do of other parts of the financial system.

In addition, the shadow banking system is in constant flux: innovations shift its boundaries; activities and participants come and go. To regulate the shadow banking system, we need a definition that does justice to these changes.

The Financial Stability Board has therefore opted to define the shadow banking system fairly broadly as "the system of credit intermediation that involves entities and activities outside the regular banking system". Put simply, this definition covers bank-like entities and bank-like activities which are not subject to banking regulation.

Examples of shadow banking entities include money market funds, hedge funds, asset management companies and financial vehicle corporations. Fittingly, their business is often described as "non-bank banking" or "parallel banking". Examples of shadow banking activities include securitisations, securities lending and repos.

Despite the blurred and constantly shifting boundaries, we can attempt to estimate the size of the shadow banking system. The Financial Stability Board, for instance, puts the figure for assets under management in the shadow banking system at US$71 trillion. That would make the shadow banking system about half as big as the regular banking system. However, this global aggregate does not capture major regional differences. For example, in the United States the shadow banking system is about 175% the size of the regular banking system, whilst the ratio in Germany is only around 25%.

As well as the size of the shadow banking system, its rate of growth also varies between regions. In 2012, the system saw its sharpest expansion in emerging market economies, with China recording the fastest growth worldwide. By contrast, the German shadow banking system grew comparatively slowly. Overall, the global shadow banking system has grown rapidly in recent years: between 2002 and 2012, its assets under management expanded by US$45 trillion.

This growth could continue into the future. For instance, more stringent regulation of banks may cause activities to migrate to an increasing extent into shadow banking – what is referred to as regulatory arbitrage.

However, it would be wrong to attribute the growth of the shadow banking system to regulatory arbitrage alone. Growth is also being driven by demand for the specialised products and services offered by the system. Institutional investors in particular make use of shadow banking products – such as repo trades – as an alternative to traditional bank deposits.

In consequence, the effects of shadow banking on financial stability are not entirely clear. On the one hand, the system undeniably fulfils an economic role: it offers alternative sources of funding to enterprises in the real economy as well as to banks, thereby adding to diversification and specialisation. In general, that enhances both the efficiency and the resilience of the financial system.

On the other hand, the shadow banking system also harbours risks. If activities are shifted into shadow banking as a result of regulatory arbitrage, then the concomitant risks are shifted too – and thus sometimes moved out of reach of the regulatory access that is actually needed.

However, the shadow banking system may be a source of risks other than those deriving from regulatory arbitrage. Shadow banking participants undertake maturity and liquidity transformation, they engage in the transfer of credit risk, and they operate with leverage. This means they carry out a range of bank-like functions which are associated with bank-like risks. At the same time, however, there are two key differences compared to the regular banking system. First, shadow banking participants and activities are not subject to banking regulation. Second, shadow banking participants have no access to central bank liquidity, nor do they benefit from public backstops such as deposit insurance schemes.

The consequence of this structure is a latent risk of runs on shadow banking participants. A run may lead to liquidity bottlenecks which can only be cleared by rapid deleveraging. That in turn may contribute to a collapse in prices on the financial markets, and thus exacerbate the problems in procyclical fashion. At the same time, the structure of many of the transactions conducted in the shadow banking system means that the participants are closely interconnected. Thus, contagion effects within the system are highly likely.

These systemic risks within the shadow banking system may then spill over into the regular banking system. The latter is linked to the shadow banking system through a number of channels. Partly this is because banks are directly involved in shadow banking. At the same time, many banks are connected indirectly to the system through liquidity facilities, claims on shadow banking participants and common exposures in individual markets.

Thus, the shadow banking system may well be a source of systemic risk. Accordingly, it is very high up the G20 reform agenda. In November 2010, the G20 asked the Financial Stability Board and other international standard setters to develop approaches to ensuring better supervision and regulation of the shadow banking system.

In this connection, let me be absolutely clear: the purpose of regulation is not to proscribe shadow banking activities or to drive participants out of the market when such activities and participants engender no systemic risk. The sole aim of regulation is to put a brake on systemic risk.

There are essentially two approaches: a direct one and an indirect one. Indirect regulation is aimed at the regular banking system and tries to keep a check on its links to the shadow banking system. Direct regulation, on the other hand, takes direct aim at shadow banking participants and activities.

In terms of indirect regulation, some progress has been made in the reforms to the Basel framework. For instance, capital requirements for various connections to the shadow banking system were increased – including for risks arising from securitisation and from liquidity facilities for securitisation vehicles. In addition, banking supervisory liquidity ratios may help to stem systemic risk – where macroprudential considerations are factored into defining them.

Money market funds constitute one example of direct regulation of participants. US money market funds in particular bear a strong resemblance to banks. For investors, there is very little difference between these funds and a bank account – including access to cash at ATMs. The main problem comes with money market funds which operate with constant share values, such that investor deposits have a constant value. With funds like this, losses are not distributed evenly across all investors. Instead, a "first come first served" rule applies. Those who withdraw their deposits first get back the full amount, while those who act too late have to accept corresponding losses. This rule makes such money market funds susceptible to runs.

Therefore, a shift to money market funds which operate with variable share values is an important step in making the sector more stable – in these funds, losses are shared evenly by shareholders. Regulatory proposals in this regard have now been published in both the United States and Europe. However, these are focused on alternative measures such as capital cushions, liquidity charges and delayed withdrawal for funds with a variable valuation. These initiatives are to be welcomed, but an obligatory shift to variable share valuation would be better.

An example of direct regulation of activities is that applying to securities financing transactions. In these transactions, a German bank, for instance, provides a UK-based hedge fund with short-term financing against collateral in the form of securities. In a liquid market, this type of transaction can contribute to a procyclical build-up of leverage. Since the securities furnished as collateral are generally used several times over, this creates long chains of transactions involving many different participants – participants in both the shadow banking system and the regular banking system. This adds to the degree of interconnectedness within the financial system, increasing the risk of contagion effects. To counter this risk, the European Commission put forward a proposal for a regulation at the end of January. Under the proposed rules, securities would only be reusable if the provider of collateral agreed to it. These moves to put a brake on systemic risk in the securities financing markets are without doubt a step in the right direction.

4 Conclusion

Ladies and gentlemen

The financial system needs appropriate regulation so that it can function as a reliable provider of services to the real economy. The crisis laid bare a number of gaps in the regulatory framework applying to the financial system, gaps which we now need to close.

We have already come a long way in this, but we have not yet reached the goal. We cannot allow ourselves to come to a standstill, either with regard to the too-big-to-fail problem, or with respect to the shadow banking system and other issues still requiring more work.

Standing still would in fact mean falling behind, because the financial system is constantly changing. Thus, regulation is aiming at a target which is forever receding. And that is a good reason to make progress somewhat more swiftly – regardless of whether we are talking about regulation from the point of view of banking supervision or in terms of financial stability.

Thank you very much.