Andreas Dombret: What is “good regulation”?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bundesbank symposium on “Banking supervision in dialogue”, Frankfurt am Main, 9 July 2014.

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1. Introduction

Ladies and gentlemen

Welcome to the Bundesbank’s 18th banking symposium. I’m delighted to see that we have a full house again and that our programme has attracted participants from all across Germany. I would also like to welcome my colleagues on the Bundesbank’s Executive Board: Mr Böhmler, Mr Nagel and Mr Thiele. Deputy President Buch and President Weidmann would like to have joined us here today, but have prior engagements; they pass on their best wishes. As you can tell, the Executive Board members are of one mind when it comes to banking supervision.

This symposium is something of a debut for me, as it’s the first time that I’ve participated in this event in my new role as the Executive Board member responsible for banking supervision. And this comes in a crucial year for banking supervision. Before I go any further, I would like to give a special mention to my colleague on the Executive Board, Joachim Nagel. As you may well know, Mr Nagel stood in as the board member responsible for banking supervision for several months after our Deputy President, Ms Lautenschläger, left to join the ECB in January. Mr Nagel, we would all like to thank you very much for the extremely valuable work you have done in the sphere of banking supervision.

As you may know, I myself worked at commercial banks for many years before taking up office at the Bundesbank in 2010, which means that I have experienced supervision from both sides of the fence. And I know that all of us – supervisors and supervised alike – have the same goal: a stable banking system for a strong economy. Yet we can only succeed if we work together. So I propose that we use this event as an opportunity to share our views and experiences.

Dialogue is vital to banking supervision. That is always true, but never more so than in periods of major upheaval. And I’m sure you’ll all agree that we are currently experiencing precisely such a phase. So I’m especially pleased that Danièle Nouy, the Chair of the Supervisory Board of the new Single Supervisory Mechanism, will be sharing her thoughts with us today. But first, I’d like to give you my perspective on the situation. My speech will centre around two key questions: “what is ‘good regulation’?” and “what is ‘good supervision’?”

2. What is “good regulation”?

Banks and savings institutions play a vital role in any modern economy and, indeed, in our everyday lives. We simply could not manage without them. Entrepreneurs, bankers and individuals alike: we all benefit from a stable banking and financial system. Financial stability is therefore a public good, not just nationally but on a global scale too. At the same time, banking can sometimes be associated with external effects. It doesn’t just affect banks and their business associates; it also has an impact on third parties with no stake in the game. And during the financial crisis, those third parties were the taxpayers.

Regulators and supervisors can rectify a market failure of this kind, and it is in the public interest for them to do just that. It isn’t a question of whether but of how to regulate. And it is this matter of how to regulate that I would like to discuss now – not by focusing on specific legal provisions, but by outlining certain principles which I consider particularly important.

To clear up any misunderstandings right from the outset, I would like to emphasise that it isn't the job of regulators and supervisors to keep each and every bank in business. In a market economy, it has to be possible for banks without a workable business model to fail – however large, interconnected or significant they may be. The task of regulators is to create a framework in which market forces can take effect without destabilising the entire financial system.

Yet it is vital to ensure that this framework is not overly rigid; we should not confuse stagnation with stability. The financial system is in constant flux, and regulation has to keep pace with it. Tradable asset backed securities are a case in point. Introducing timely and adequate regulation on this innovation might have prevented the financial crisis from taking such a dramatic course. The regulatory framework therefore needs to be just as adaptable as the financial system itself.

It is now widely accepted that innovations rarely make the financial system simpler and usually make it more complex. The key financial innovation in the ancient Phoenician civilisation was the forward transaction – a financial instrument that you will all be familiar with today. Since then, financial innovations have become increasingly complex – to the point where the instruments used today are often understood by only a handful of experts.

But does that mean that we need increasingly complex regulation too? Or could it be that we need only a few simple rules to ensure effective supervision and safeguard financial stability?

One current example of this debate concerning simple and complex regulation is the leverage ratio. The advocates of a simple leverage ratio for banks want to replace the current risk-based capital rules with a "blanket" capital requirement. They believe that the same percentage of capital should be held against all assets, regardless of their risk. I have to admit that the idea appears appealingly simple at first sight. And it would avoid the mistakes and manipulation that can arise during the complex process of calculating risk weights.

Yet a leverage ratio would also create the wrong incentives. If banks had to hold the same percentage of capital against all assets, any institution wanting to maximise its profits would probably invest in high-risk assets, as they produce particularly high returns. This would eradicate the corrective influence of capital cover in reducing risk.

Weighing up the advantages and disadvantages of simple and complex regulation, it is probably better in this instance to use risk weightings in combination with the leverage ratio – which is precisely what the new rules envisage. Consequently, my answer to the first question is that regulation must be as simple as possible and as complex as necessary.

Yet sometimes a certain set of circumstances can make regulation needlessly complex. One example of this is the leverage ratio. The calculation of this ratio, which is essentially quite simple, is complicated by the fact that accounting standards vary from country to country. Intricate conversion calculations are needed to make leverage ratios based on US accounting principles comparable to those based on the standards used in Europe. If accounting standards were harmonised at a global level, the applicable regulation would be simpler.

However, the more complex the regulation, the more important it is to adhere to another principle: coherence. I believe that regulation must be coherent on at least three levels.

First, regulation has to be coherent across borders and regions. We have a global financial system, and it therefore requires global regulation. Where regulation varies from country to country, there is a danger of regulatory arbitrage – of banks moving their business to countries with the lightest-touch regulation. The problem with this behaviour is that the risks stemming from these transactions could potentially affect the entire financial system. This is why the G20 have made the issue of financial market regulation a priority. In cooperation with the Financial Stability Board and the Basel Committee on Banking Supervision, they are working to develop a coherent regulatory framework at the global level. Even so, I'm concerned to see that some countries outside Europe are adopting their own regulatory initiatives which breach the principle of cross-border coherence. I believe that the danger of banking regulation one day returning to the principle of "every man for himself" needs to be taken seriously.

Yet regulation not only needs to be coherent across borders and regions but also across different sectors. Here, too, the central issue is the danger of regulatory arbitrage. One current example is the growth of the shadow banking industry, where financial enterprises conduct business which creates bank-like risks but is either regulated insufficiently or not at all. In many cases, these risks are not even recorded. Yet the shadow banking industry may become a source of systemic risk. We therefore need to expand the regulatory framework in this area to ensure that it is coherent.

Third, it goes without saying that the content of regulation also needs to be coherent. The capital rules are a case in point. Unlike for all other forms of credit, banks do not have to hold capital against government bonds in line with the risks that they carry, and this inconsistency has dangerous side-effects. Since the euro-area sovereign debt crisis – if not before – it has become clear that government bonds are anything but risk-free. In this area too, we should work to restore the coherence of regulation in the medium term.

As crucial as coherence is, however, regulation also has to be guided by the principle of proportionality. It is appropriate to apply strict regulation to large institutions which are closely interconnected within the financial system: the entities we call "systemically important institutions". Equally, however, we must take care not to overburden small and medium-sized institutions; they should be governed by simpler regulation. The standardised approaches applied in supervision and de minimis thresholds such as those used in reporting can help us to achieve this proportionality.

Ladies and gentlemen, I've outlined four different principles for ensuring good regulation.

- First, regulation has to be flexible and able to keep pace with developments in the financial system.
- Second, regulation must be as simple as possible and as complex as necessary.
- Third, regulation has to be coherent in terms of its content, as well as across borders, regions and sectors.
- Fourth, regulation must be guided by the principle of proportionality.

Abiding by these principles will not, of course, allow us to solve every single regulatory problem. Yet they do provide us with a yardstick for assessing regulatory provisions. And I do believe that is very valuable.

3. What is "good supervision"?

All in all, though, even the best regulation is useless if nobody is overseeing compliance. And that is precisely the job of supervisors. Supervisors have to make sure that, in the banks' search for profit, they follow the rules and do not lose sight of the public interest.

Do supervisors have to be the "better bankers"? No, absolutely not. Business decisions must be left to those being paid to make them. However, supervisors have to know – and understand – how banking works. Against this background, I personally would very much welcome an increase in the migration of staff between the banking industry and the supervisory agencies. I therefore consider it a good sign that a large number of bankers have been applying to join the ECB's new European supervisory mechanism. And at the Bundesbank we are also noting a rise in the number of bankers showing an interest in and applying for vacancies in our banking supervision units.

It is also important for supervisors to always remain aware of their true objective: to uphold the public interest. They must not allow themselves to succumb to a sort of "Stockholm Syndrome for supervisors" and confuse the public good with that of the supervised banks.

3.1 The new European supervisory mechanism ...

This is an area where the new European supervisory mechanism can make a key contribution. By adding a European perspective to the national view, it will put more distance between the supervisor and the supervised entity. This will minimise the danger of supervisors getting all-too-close to their banks and thus treating them with "kid gloves" out of national interest.

All in all, European-level supervision is the most important step towards financial market integration in the euro area since the launch of our single currency. It is a logical step, too, since a single monetary policy also requires integrated financial markets – which includes, without doubt, European-level supervision.

An in-depth examination of all banks which will later be supervised directly by the ECB is now underway. The objective of this comprehensive assessment is to ensure that the new European supervisory authority has a smooth launch. We therefore view all measures that will strengthen the capital of German banks very positively. Over the past few months, many banks have begun to move in the right direction.

Clear communication is essential to both the asset quality review and the stress test. I believe that the process should be as transparent as possible and the banks should be involved at the earliest possible stage as far as the law allows.

Transparency will be especially important in the join-up of the results of the stress test and the asset quality review. In my view, we should work from the bottom up wherever possible – in other words, on the basis of specific data provided by the banks. Generalised assumptions should be used as little as possible.

The creation of the new Single Supervisory Mechanism, or SSM, based at the ECB is surely the single greatest challenge we are currently facing. I am therefore particularly pleased that Danièle Nouy will be giving us a first-hand progress report today. The Bundesbank, for its part, is doing all it can to assist in the creation of the SSM.

3.2 ... and its repercussions for supervision in Germany

At this juncture, some of you might be asking whether German supervisors are digging their own grave. Once supervision is transferred to the European level, where will that leave the Bundesbank and BaFin? There are three points I would like to make on that subject.

First, we Germans, of all people, should not succumb to the illusion that European-level supervision spells the end of national supervision. After all, from 4 November of this year, out of around 2,000 German credit institutions, only 21 will actually be supervised directly by the ECB. Our BaFin and Bundesbank supervisors will remain responsible for all other German institutions.

Second, institutions under the ECB's supervisory responsibility will be supervised by "joint supervisory teams" in the future, to which the Bundesbank and BaFin staff members will contribute their expertise. In addition, they will support supervision in other countries. Put simply, we're ceding, in whole or in part, responsibility for supervising 21 German institutions, but becoming involved in the supervision of 99 foreign institutions.

The Bundesbank's role in this area will build on our expertise and experience, as well as our nationwide presence. Over many years, we have built a close working relationship with you, ladies and gentlemen.

The separation between supervisors and decision-makers has proved to be an efficient system. That is precisely why we should make similar arrangements for the new European supervisory mechanism, with the Bundesbank performing ongoing supervision, and the ECB taking the decisions.

It just so happens that, at the same time as we are holding this forum, Germany's Federal Cabinet is discussing amendments to the German Banking Act (Kreditwesengesetz) today. The cabinet will consider whether changing this division of tasks and interrupting the direct reporting channel from the Bundesbank to the ECB constitutes "good regulation". I doubt it. I believe that the Bundesbank has to be on an equal footing with the other supervisors. That is the only way to ensure effective European-level supervision.

4. Conclusion and outlook

Ladies and gentlemen, the French writer François Fénelon once claimed that, "the more you say, the less people remember". As this obviously isn't my aim, I would like to conclude my remarks by taking a peek into the future.

The past history of regulation has been one of constant ups and downs. Periods of deregulation have usually been followed by a crisis, then followed by a period of re-regulation, and again by a period of deregulation. It is precisely in phases of re-regulation that banks tend to complain about the time and money it costs – and the present period is no exception. But are we really overregulating? If we look at the benefits to society of a stable banking system and the social costs of a banking crisis, I believe the costs of regulation are justifiable.

However, for the future I would like regulation to evolve somewhat more steadily and adapt more quickly to new challenges: the low-interest-rate phase, high-frequency trading, charges of manipulating the LIBOR or the setting of forex rates and gold prices, to name just a few examples. We should not wait until the aftermath of the next crisis to come up with ways of responding to these challenges.

I do not believe, however, that regulators and supervisors are all-knowing and all-powerful. As I noted at the beginning of this speech, we can only maintain financial stability if we work together. You, the bankers, are just as responsible as us, the supervisors and regulators. I am well aware that the number of "bad apples" is very small. However, their behaviour causes all of us to suffer: the public, when a crisis breaks out, and the bankers, when the public tar them all with the same brush.

Yet we should be aware that the value of the financial system is measurable against one key criterion: your reliability, ladies and gentlemen, as a service provider to the real economy. So let's use this understanding to work together to make the financial system more stable – the ECB, BaFin, the Bundesbank and the banks. This symposium is a magnificent opportunity to exchange views and develop ideas. Let's use it.

Thank you very much.