Andreas Dombret: Financial regulation as a global challenge

Introductory statement by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a roundtable discussion organised by the Canon Institute for Global Studies and the EHESS, Tokyo, 15 July 2014.

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Ladies and gentlemen

Thank you for having me today; it is a pleasure to be here.

For me, one of the central lessons from the financial crisis is this: the financial system is global in scope, and it therefore requires global regulation. To push this idea further, I would define the term "global" in at least three dimensions and argue that regulation should be consistent in all of them.

First, regulation needs to be consistent across borders and regions. 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 that are transferred 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 consistent 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 consistency. I believe that the danger of banking regulation one day returning to the principle of "every man for himself" needs to be taken seriously. We must not let this happen.

Second, regulation not only needs to be consistent 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.

With banking regulation being tightened, banks have even more incentives to move their business to the shadow banking system. Thus, 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 consistent.

Third, regulation needs to be consistent across asset classes. Take the regulatory treatment of government bonds as an example. 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. Thus, I cannot see a single good reason why banks should not have to back government bonds in their balance sheets by capital, but I see many reasons why they should. In this area too, we should work to restore the coherence of regulation in the medium term – not least to address the sovereign-bank nexus.

To sum up: Financial regulation needs to be consistent across borders, across sectors and across asset classes. Ensuring these three dimensions of consistency will help to make the financial system a safer place.

However, while being a safer place in the aggregate, the financial system is not necessarily a safe place for individual banks. After all, we live in a market economy and creative destruction is a central element. Individual banks must be able to fail like any other enterprise.

This must also hold for large banks which are often labelled “too big to fail”. To allow them to fail without destabilising the entire system we need resolution mechanisms. And here again, we have a global dimension. Banks that are deemed too big to fail are globally operating enterprises; resolving them requires a great deal of international cooperation.

Consequently, the Financial Stability Board has developed a set of principles for the resolution of systemically important institutions. These principles are the basis for resolution mechanisms around the world, including the Single Resolution Mechanism in the euro area.

Ladies and gentlemen, I think it is obvious that to make the financial system a safer place we have to cooperate in regulation, in supervision, and in the resolution of banks. Globalisation and the experience from the recent crisis have made international cooperation a central principle of economic policy.

Thank you.