Andreas Dombret: The quest for stability – regulating and supervising banks

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Handelshochschule Leipzig, Leipzig, 2 October 2014.

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1. Introduction

Ladies and gentlemen

Thank you for inviting me to the Handelshochschule in Leipzig. It is a pleasure to be here.

First of all, let me tell you a short story I heard the other day. A young banker decided to get his first tailor-made suit. As he tried it on, he reached down to put his hands in the pockets but, to his surprise, found none. He mentioned this to the tailor, who asked him, "You're a banker, right?". The young man answered, "Yes, I am.", to which the tailor replied, "Well, whoever heard of a banker putting his hand in his own pocket?".

It is certainly true that the reputation of bankers has suffered during the crisis. But still, 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.

2. Regulating banks

What is the job of regulators? Well, in a nutshell, their job is to create a framework that allows market forces to produce efficient outcomes while also preventing instability and crises. 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. The regulatory framework therefore needs to be just as adaptable as the financial system itself – this is the first principle on my list.

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 every student of financial economics is 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, the second principle of good regulation 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 again 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 the third principle on my list: 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 a fourth principle: proportionality. It is appropriate to apply strict regulation to large institutions which are closely interconnected within the financial system. 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 believe that is very valuable in our quest for stability.

3. Supervising banks

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.

In 2010, the IMF published a paper entitled: "The Making of Good Supervision: Learning to Say No".[1] This idea of "saying no" refers to the fact that good supervisors must have the will to act. This means that they must 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.

Nevertheless, supervisors must not only be willing but also able to act. Let me give you an example. It certainly isn't the job of 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, if banks are very large or interconnected, their failure might disrupt the whole system – they become "too big to fail". The ability of supervisors to resolve the bank in question is then very limited. In fact, the authorities might be forced to bail out the bank with taxpayer funds in order to prevent a systemic meltdown.

Regulators therefore have to create a framework that gives supervisors the ability to act. They must be able to resolve or restructure a failing bank – however large, interconnected or significant it may be. Over the past few years we have made some progress toward this objective. In Europe, a resolution mechanism for banks will be in place from the beginning of 2016. However, we also have to address the "too big to fail" problem at the global level. We have taken some small steps towards this goal but we still have a big leap ahead of us. I therefore consider the "too big to fail" problem largely unresolved.

But let's return to the issue of good banking supervision. Good supervisors need both the will and the ability to act. My example illustrates how the ability to act depends on the regulatory framework. But there is more. Both the will and the ability to act also depend on the institutional set-up of banking supervision.

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[1] Viñals, J. et al. (2010), The Making of Good Regulation: Learning to Say "No", IMF Staff Position Note, SPN/10/08. Washington, DC.

And in this area, Europe is on the eve of a major change. One month from now, banking supervision in Europe will be transferred from the national to the European level. On 4 November, the ECB will take on the direct supervision of the largest 120 banks in the euro area. These banks account for more than 80 % of the aggregated balance sheet for the euro-area banking sector. This will make the ECB one of the world's largest supervisors.

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.

European banking supervision will allow banks throughout the euro area to be supervised according to the same high standards. In addition, cross-border effects can be covered better through joint supervision than by national supervisors. And adding a European perspective to the national view will put more distance between the supervisory authority and the entities it supervises. 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.

European banking supervision will thus enhance the effectiveness of banking supervision. And, together with the European resolution mechanism for banks, it will definitely help to increase the stability of the financial system.

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. The bankers are just as responsible as the supervisors and regulators. I am well aware that the number of "bad apples" among bankers is very small. However, their behaviour causes everybody 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: its reliability as a service provider to 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.