

Jens Weidmann: Banking union and regulatory reforms – mission accomplished?

Keynote speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the 24th Frankfurt European Banking Congress, Frankfurt am Main, 21 November 2014.

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1. Introduction

Ladies and gentlemen

I am very pleased and honoured to speak here today before such a distinguished audience. So thank you for the invitation.

Since I am speaking ahead of a panel discussion entitled “Banking Union and Regulatory Reforms: Mission Accomplished?”, I would, if I may, like to present a central banker’s view of the respective issues.

The history of banking regulation is almost as old as the history of banking itself. One instance of very tough regulation was reported by the Spanish economist Huerta de Soto: in the year 1300, a detailed set of regulations to control banking were established in Catalonia.¹

Bankers who went bankrupt were forced to live on a strict diet of bread and water until their depositors had been fully reimbursed.

One would imagine that this regulation was an effective way of preventing bankers from engaging in overly risky behaviour. Apparently, it was not. In 1321, Catalonian banking regulation was tightened: henceforth, any banker who failed to meet his clients’ demands faced the threat of being beheaded in front of his bank.

I would say that under such a rigid regulatory regime, banking really was a risky business.

Ladies and gentlemen, I can reassure the bankers among you that no regulatory authority wants to implement measures from the Middle Ages.

Contemporary banking and medieval banking have as much in common as a Ferrari and a donkey cart. However, both can get into a nasty accident if their drivers navigate the roads too quickly and too recklessly.

Traffic rules are there to protect drivers and their vehicles as well as other road users. You could say that the regulatory authorities are the traffic police of the financial system. With one important difference, however: Unlike a sports car that careers off the road, the failure of a commercial bank can become a systemic event.

The financial crisis taught us that the rules of the banking system were insufficient. The crisis revealed a raft of regulatory weaknesses that needed to be cured: the possibility of excessive risk-taking; insufficient loss absorbing capacities; banks that were “too big to fail” – to name but a few of the shortcomings that came to light.

2. Progress made on regulatory agenda but no question of overregulation

During the seven years that have passed since the onset of the US subprime crisis, significant progress has been made on the regulatory agenda. Unsurprisingly, there are mixed views on whether or not the implemented regulatory reforms are sufficient.

¹ J Huerta de Soto (2006), Money, Bank Credit and Economic Cycles, Auburn.

In any case, the way representatives of the banking industry view matters is quite unlike the general public's perception: while the prevailing impression among the public at large is that next to nothing has happened, industry representatives are already complaining of a surfeit of regulation. In my opinion, neither is true. Regulation has been significantly tightened, but there can be no question of overregulation.

The most important regulatory step was the introduction of stricter capital requirements and new liquidity rules under Basel III. The new capital adequacy rules that were implemented into European law by CRD IV and CRR with a transition period until 2019 require banks to hold better and more capital.

According to the Basel Committee's latest Basel III monitoring exercise, most large internationally active banks already meet the fully implemented capital minimum requirements. Banks' loss absorbing capacity is much better than it was before the financial crisis.

Between mid-2011 and end-2013, the average CET1 ratio of large and internationally active German banks, for example, almost doubled from just 5% to 9.5%. The leverage ratio of those banks improved from 1.7% to 2.6%.

The introduction of the leverage ratio – which has a target ratio of 3.0% under Basel III – is without doubt a sensible supplementary measure to the risk-based capital requirements. Starting in 2015, banks will be required to disclose the leverage ratio, with a view to migrating it to a Pillar 1 requirement by 2018 after a final calibration.

The leverage ratio is a useful complement as a backstop, all the more so as the Basel Committee has identified that risk weights for credit risk vary significantly across banks using an internal ratings-based approach. The risk-based approach must, however, remain a key element of the capital rules.

Having a leverage ratio as the single rule would offer banks problematic incentives to take greater risks. I therefore agree with my colleague Mark Carney from the Bank of England who has said, in this context, that it is sometimes good to wear a belt and suspenders to prevent your trousers from falling down.

That being said, the flaws of the risk-based approach need to be addressed. To improve the comparability of the methods used to calculate the capital requirements, the Basel Committee is aiming to curtail banks' leeway in weighting risk.

For example, it is hard to assess the probability of default for low-default portfolios which include exposures to sovereigns, large companies or banks because – as the name suggests – the respective credit events are very rare.

To some extent, the calculation of regulatory parameters for such low-default portfolios falls under what is known as the "turkey illusion": Imagine you are a turkey. Every day you are approached by a man who feeds you. What kind of mental model of what happens when he appears do you think you'll build up? However, Thanksgiving is coming...

Measures under consideration to reduce the leeway for banks using an internal-ratings based approach include the implementation of floors based on the standardised approach, restrictions on using internal estimates of certain parameters for risk calculation purposes, and the exclusion of certain asset types from the model-based approach.

Efforts are also underway to make the standardised approach more risk-sensitive. However, it should be noted that using different methods to calculate risk-weighted assets is not a problem per se. To some extent, deviations are acceptable and reasonable; otherwise we would ultimately be calling into question the very rationale of the internal models-based approach.

3. Beyond Basel III

When Basel III is fully implemented, regulatory capital requirements will be significantly higher and tougher than under Basel II, and the financial system will be more stable than before. A typical credit institution will have to achieve a capital ratio of 8% plus various buffers. But will that be enough?

To give a profound answer to this question, we would first need to have an idea of what would be an optimal, or at least an adequate, capital ratio.

Academic research on this subject is not very broad. However, a recent study by several central bank economists found that a capital ratio of around 11% would be a reasonable figure.² That number exceeds the Basel III minimum requirement but falls well short of “more radical proposals”.

Of course, there is a trade-off between the benefits and costs of higher capital requirements which lies at the heart of the optimisation problem in the study I just mentioned. On the one hand, higher capital requirements reduce bank leveraging, the risk of bank failures and the implicit subsidies given to banks on account of deposit insurance schemes backed by the government and ultimately the taxpayer. On the other hand, excessively high capital requirements may unduly curtail banks’ ability to provide credit to the economy.

We should be aware that simulations like this are highly dependent on model specifications, so the results of these models need to be taken with a pinch of salt – and what is more, additional research is certainly needed in this regard. But it might encourage banks, particularly those which are currently only just managing to meet the Basel III requirements, to increase their capital beyond these requirements.

One of the reasons why the banking industry usually objects to higher capital ratios is that equity is considered to be costlier than debt.

There are good reasons why shareholders are better remunerated than creditors: equity is riskier than debt because debt is senior to equity and not performance-related. Moreover, equity allows shareholders to have more of a say in a company’s business activities.

The cost advantage of debt over equity, however, is also explained by differences in the tax treatment of various forms of investment. Equity-based financing is placed at a disadvantage to debt-based financing.

Admittedly, reforming business taxation is notoriously difficult and would require a strong political commitment. Also, efficiency improvements in business taxation often go hand in hand with revenue shortfalls or acute uncertainty over the fiscal effects of legal changes.

Of course, financial stability considerations are only of secondary importance in the field of business taxation. However, introducing a (more) neutral form of tax treatment for debt and equity financing would generally be efficiency-enhancing, besides reducing the attractiveness of being highly leveraged.

Improving the neutrality of business taxation in terms of the source of financing appears to be a topic that is well worth considering for the reform agenda. This is not an issue specific to banks but one which generally holds true for business taxation. The task of ensuring financial institutions’ capital adequacy is, nevertheless, primarily a regulatory one.

Besides the Basel III regime, a host of other prudential rules have been tightened in response to the financial crisis. The stricter overall regulatory landscape has induced regulatory evasion: financial activities are being shifted out of the regulated banking sector into the unregulated shadow banking sector.

² L Clerc et al (2014), Capital Regulation in a Macroeconomic Model with Three Layers of Default, mimeo.

According to the latest FSB Global Shadow Banking Monitoring Report, non-bank financial intermediation grew by USD 5 trillion in 2013 to reach USD 75 trillion.

The growing shadow banking sector is something regulators have to watch closely. Given that shadow banking entities essentially cannot tap central bank liquidity and do not benefit from backstops such as deposit insurance schemes, they are latently exposed to the risk of runs.

Shadow banks can thus become a source of systemic risk, especially when they are structured to perform bank-like functions like maturity and liquidity transformation and when they are highly interconnected with the regular banking system.

From a financial stability perspective it is therefore important to closely monitor shadow banks' activities and regulate them adequately. The Bundesbank therefore supports the global regulatory initiative on shadow banking under the leadership of the Financial Stability Board (FSB).

4. European banking union

The recent establishment of a European banking union, which comprises the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), is an institutional milestone on the path that leads to greater financial stability in the euro area.

The banking union eliminates a serious flaw in the institutional make-up of Economic and Monetary Union. In this regard, former ECB president Wim Duisenberg was already on the right track. He suggested back in the days of the Delors Group that a unified monetary policy ought to be combined with unified banking supervision.

In the late 1980s, however, European politicians were not ready to take that decision. Having experienced a serious financial crisis in the euro area, this is at least one thing that has changed.

Less than three weeks ago, the ECB assumed responsibility for the supervision of euro-area banks and I would like to congratulate Danièle Nouy and her staff for accomplishing the Herculean task of establishing a workable European banking supervisory set-up within one year and successfully implementing the comprehensive assessment of the largest banks. Needless to say, it would have been "mission impossible" if national supervisors had not acted in concert with the ECB.

The SSM is expected to reduce regulatory arbitrage and remove home bias from the world of banking supervision.

The Single Resolution Mechanism is a necessary complement to the common supervision set-up because it brings liability and control into alignment. To quote the European Systemic Risk Board's scientific advisers: "Without credible cross-border resolution regimes, banks are 'global in life [but] national in death'".³ One of the core elements of the new resolution framework will be the bail-in regime. It sets out a clear liability cascade for failing banks. In future, investors will be first in line to shoulder the costs of bank failures – and rightfully so, since they were the ones that assumed the risks and benefited from the returns in the first place.

An essential requirement for the credibility of the bail-in regime is the existence of sufficient bail-in-able capital. In this regard, the G20 leaders' decision to endorse the Financial Stability Board's proposal to introduce a total loss absorbing capacity (TLAC) for global systemically important banks (G-SIBs) at their meeting in Brisbane a few days ago marks an important step forward.

³ ESRB (2014), *Is Europe Overbanked?*, Reports of the Advisory Scientific Committee, No 4.

According to the FSB proposal, the world's 30 largest banks will be required to hold TLAC in a range of 16–20% of their risk-weighted assets and 6% of their unweighted assets. The implementation of the TLAC will help to mitigate the “too big to fail” problem, which is a particularly relevant topic for G-SIBs.

The TLAC proposal is neutral in terms of banks' structures. In order to be able to absorb losses in resolution, TLAC instruments need to be subordinated, regardless whether this is achieved via contractual, statutory or structural subordination. Moreover, comprehensive studies will be carried out to analyse the potential impact of the TLAC proposal, following which the TLAC requirement will be finalised.

The euro area has already introduced a minimum requirement for own funds and eligible liabilities (MREL) which applies to all institutions that are covered by the BRRD. But so far, these liabilities can be held by other financial institutions. In order to tackle the issue of contagion and thus bolster financial stability, this standard should, however, discourage other financial institutions from holding these liabilities, eg by setting limits or deductions from own funds.

Therefore, I agree in essence with Goethe University's Jan-Pieter Krahen who said in an interview with Handelsblatt last week that “bail-in bonds should only be held by institutions [...] that are [...] able to bear the [...] shock of a bank's insolvency without suffering a run themselves.”

Assuming the bail-in mechanism works in practice, this will also be an important step towards breaking the disastrous sovereign-bank nexus. However, more will need to be done if we are to overcome this nexus, which became a vicious cycle during the crisis.

In particular, the preferential treatment afforded to sovereign bonds under the Basel III regime needs to be reconsidered. To quote Danièle Nouy: “sovereigns are not risk-free assets. That has been demonstrated, so now we have to react.”

Putting an end to zero risk weighting and particularly applying a large exposures regime to sovereign bonds would trigger substantial repercussions, but these would be manageable if they were phased in over a transitional period – which would undoubtedly need to be granted.

5. Conclusion

Ladies and gentlemen, let me conclude by making a reference to the title of the following panel discussion: “Banking Union and Regulatory Reforms: Mission Accomplished?”

Without wishing to pre-empt the panel debate, I would suggest we should be cautious about declaring “mission accomplished”.

Besides discussing individual regulatory measures, however, in my view it would be essential to consider the interplay between the various measures that have already been implemented.

Without doubt, the banking sector has needed to digest sizeable shifts in the regulatory environment. This obviously needs to be considered when banks are called upon to extend their loans to the private sector. Bearing in mind the stricter capital requirements, it is not surprising that their repercussion on banks' activities make them wary when it comes to increasing their lending.

That being said, the weak credit dynamics in the euro area are also caused by the moderate economic recovery and the persistent need to deleverage in the banking sector and the non-bank sector. Hence, more than just favourable refinancing conditions will be needed to stimulate credit growth.

It is far more important to improve the longer-term revenue prospects of non-financial corporations. And it is important to improve sustainably job perspectives. Both can only be

achieved through structural reforms which bolster competitiveness and boost economies' growth potential.

A prosperous economy needs healthy banks, but the opposite is just as true: healthy banks need a prosperous economy.

Thank you for your attention.