Andreas Dombret: Overshooting the mark? Banking regulation and its implications for banking business

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1. Introduction

Ladies and gentlemen

Do you think that banking regulation and its implications are the stuff of which myths are made? For my part, I was sceptical about that for a long time. Nevertheless, the last two years as a banking supervisor have taught me better.

That is because, regrettably, the question of whether banking sector regulation has overshot the mark is discussed not only on the basis of objective arguments, but also frequently with reference to myths that have no rational basis. In the next few minutes or so I shall explain my position here with regard to what implications are objective criticism and which are more vague myths.

2. Too much reform or too little?

Eight years ago we saw the outbreak of the biggest financial and economic crisis since the Great Depression in the 1930s. Right at the onset of the crisis, the heads of state or government of the G20 countries agreed to initiate global regulatory reforms. It was obvious to everyone that something had gone seriously wrong in the preceding years and that it now had to be put right.

At the beginning of this year, the Basel Committee on Banking Supervision and the G20 heads of state or government finally decided that the outstanding reform of the Basel framework – known as Basel III – was to be finalised by the end of 2016. Some of you will be of the opinion that the Basel III reforms, which were adopted in 2010, already went a very long way. That is, of course, correct. But even back then, there was agreement that there would still have to be a number of fundamental improvements to the framework and that these could only be worked out over the long term.

In plain terms, that means that some major improvements to the Basel framework will not be finalised before the end of this year. But then we shall have a coherent, sound and global regulatory framework for credit institutions.

Regulators repeatedly hear calls for the reform of banking and financial market regulation now to be brought to completion. More than that: I often hear calls – couched in politically correct language, of course – for parts of the reforms to be scaled back again. On the other hand, there is a desire for reforms to go much further. This is expressed by well-regarded experts such as Paul Volcker, Martin Hellwig, as well as by Nobel Prize winners Joseph Stiglitz and Eugene Fama.

Between these two positions there is also a third one. Its proponents firmly believe that the current reform projects will eliminate the existing shortcomings of the regulatory framework and that the reforms therefore have to be completed. After that, we should monitor how the new rules work in practice before thinking about new regulatory projects.

Behind that third position is where I align myself. As I see it, it is totally right that we cannot leave it forever and a day to finalise the reforms. By the same token, I firmly believe that we have to bring the current reforms to a reasonable conclusion. Only then can we create a consistently stable regulatory framework which lessens the probability of future crises. I think

that the time frame agreed by the Basel Committee and the G20 heads for completing the reforms by the end of this year is appropriate, reasonable and necessary in order to be able to present a convincing outcome. We shall complete it in 2016 – anything that does not undergo reform will stay at the present status quo.

3. Financial crises come at a cost

Before talking about the reforms and their implications, I would like to state something unequivocally: financial crises come at a cost – at a very high cost in fact. That is not a myth, it is a fact.

The fact that financial crises come at such a cost is now even something of a platitude. In other words, it is an insight that is basically of no particular value, since everyone knows it anyway. But, unfortunately, it is still something that people dismiss from their minds too often when fiscal policy and regulatory decisions are under discussion.

Just think of the global financial crisis of 2008. The costs of that crisis were simply enormous. Between 2007 and 2014, the sovereign debt of the developed G20 countries went up from about 70 % to roughly 105 % of gross domestic product.[1] Unemployment, too, in those countries increased on average by more than two percentage points. The preceding excesses of the financial sectors thus did lasting damage to economic growth potentials.

And the realisation that the enormously high costs of financial crises are socialised is a fundamental given. Taking a historical perspective, three years after a banking crisis public debt is on average 86 % higher than before.[2]

We therefore don't have to argue about whether the likelihood of crises has to be reduced as far as is humanly possible. That much is obvious. For this reason, it was absolutely correct to revise and improve the regulatory framework in response to the crisis. Basel III and the further reform components are thus the foundation of a more stable financial system.

At the present juncture, it is quite possible to say that the reforms were successful and have indeed contributed to a stabilisation of the banking sector. This is revealed, for example, when looking at the bank balance sheets: between 2008 and 2015, the banks of the euro area reduced the volume of their balance sheets by roughly 15 % and increased their capital ratios by more than five percentage points to around 15 %.[3] In Germany, the balance sheet volume during the same period was reduced by as much as 23 % – and the capital ratios went up from about 9 % to more than 15 %.

4. Myths, platitudes and constructive criticism – good regulation is relatively cheap

Time and again, I hear credit institutions complain that regulatory reform has gone too far. One of their main arguments is that higher capital requirements constrain banks' lending and thus constrict growth. They are asserting, therefore, that regulation takes a heavy financial toll on them.

That, ladies and gentlemen, is a myth. Empirical studies suggest that tighter capital requirements are in fact beneficial, and not just for stability reasons. They reveal that higher

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1 IMF World Economic Outlook Database. A similarly high level had been reached only once before since 1800: between 1942 and 1949 (see p 11 of S A Abbas, N Belhocine, A ElGanainy and M Horton (2010) A Historical Public Debt Database. IMF Working Paper WP/10/245).

2 C M Reinhart & K S Rogoff (2013), Banking Crises: An Equal Opportunity Menace, Journal of Banking & Finance 37(11), 4557–4573.

3 ECB data.

levels of equity capital are correlated with higher lending volumes – so in fact, the number of loans goes up, not down.[4]

At the same time, one could also argue that the quality of loans improves as well. The reason for this is quite straightforward: the better a credit institution is capitalised, the more its owners stand to lose if loans default and cause losses. So the more equity a bank or savings bank has, the greater its incentive to look more closely at loans. This is ultimately also one of the reasons why the overall cost of capital for credit institutions rises only slowly as equity capital levels increase – and this hypothesis is firmly backed by empirical evidence.[5] This is because equity capital not only reduces the risk of a bank running into financial distress in the first place – the improvement in credit quality also minimises the danger of a bank failure still further, which, all other things being equal, tends to dampen that bank's funding costs.

In a nutshell: the costs of good regulation, in terms of lending, are not as high as some would have you believe. In addition, we must not look at the costs of regulation in isolation. They have to be compared with the cost of crises. And the costs of regulation come off as looking very reasonable – especially from the taxpayer's point of view.

Our goal should therefore be a sound and coherent regulatory framework that is geared to reducing the probability of future crises. And that is precisely what we are pushing for.

In my view, this insight still hasn't become a platitude, regrettably, but it is gaining more and more disciples. And this change of heart has also seen a slight shift in the focus of regulatory criticism. What I'm referring to is the debate surrounding the complexity of regulation and compliance.

Complexity levels have increased substantially since Basel II and been compounded by subsequent reforms – there's no doubt about that. And I, too, would admit to seeing some scope for constructive criticism in this regard. I'm not alone in sometimes being taken aback by how multifaceted and detailed the regulatory framework has become in recent years.

What exactly is behind this increase in complexity? A growing number of rules, their intricacy and their degree of detail. This has made compliance with the rules an increasingly costly, time-consuming and complicated undertaking.

Regulatory complexity has now emerged as a very stiff challenge indeed. The international Basel regimes have become ever more comprehensive and intricate. A growing tendency for legislation to be implemented at the European level, and the resulting co-existence of EU and national law, have made the regulatory space even more of a maze. This mesh of different pieces of interacting legislation means that it isn't always clear what institutions need to do in order to comply with the regulatory framework as a whole. It's often a case of consulting and gauging the interplay between several articles and sections of legislation such as the Banking Act and the CRR at the same time.

Admittedly, this is not the ideal world that banks or supervisors might have imagined. But let's face it: what were the alternatives? Some voices in academic[6] and regulatory circles[7] are calling for a more drastic approach to be taken. The thrust of these proposals is to prevent credit institutions once and for all from posing a threat to the functioning of the

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[4] C M Buch and E Prieto (2014), Do better capitalized banks lend less? Long-run panel evidence from Germany, International Finance 17 (1), 1–23. T Kapan and C Minoiu (2013), Balance sheet strength and bank lending during the global financial crisis, Deutsche Bundesbank Discussion Paper No 33/2013.

[5] D Miles et al (2012), Optimal bank capital, The Economic Journal 123, 1–37; D J Elliott and A O Santos (2012), Estimating the costs of financial regulation, IMF Staff Discussion Note, 12(11).

[6] A Admati and M Hellwig (2013), The bankers' new clothes: what's wrong with banking and what to do about it. Princeton.

[7] A Turner (2015), Between debt and the devil. Money, credit, and fixing global finance. Princeton.

financial system by imposing size limits on each individual institution and setting capital adequacy requirements at a comfortably high level of 20 to 30 %. Other observers, meanwhile, are saying that it should no longer be possible to use internal risk models for calculating regulatory minimum capital requirements. Standards, they say, should be based more on a kind of "raw leverage ratio" – that is, a straightforward leverage ceiling for credit institutions without any exemptions for purportedly low-risk retail business, say, and without netting agreements etc.

Those ideas aren't feasible, if you ask me. At the end of the day, the regulatory framework is as complex as it is because of the different business models which credit institutions run, their huge size differences, and the very nature of financial transactions themselves. A comprehensive regulatory framework is more or less bound to be highly detailed because it needs to ensure that no relevant types of business are left uncovered and that every kind of risk is regulated with the prudence it deserves. The extensive rules, then, are a "next-best solution" of a kind that certainly has its merits, when viewed from that perspective. In my view, the existing, soon-to-be-completed set of rules will be with us for some time yet.

Supervisors concede that the one-off costs of adjusting to the new rules are steep, but I am in no doubt that the non-recurring transitional outlay is appropriate, given that financial stability is such a valuable public asset. And as for the ongoing costs of compliance, this is another area where we will reach a viable long-term situation once the dust has settled over the reforms.

I firmly believe that Germany's credit institutions will be able to live comfortably with this situation following a period of transition.

We will, of course, review the rules and their impact after some time, listening very attentively to take constructive criticism on board wherever possible.

Ladies and gentlemen, let's sum up the issue of complexity. The rules have become much more detailed and multifaceted; the alternative to this would have been much tighter capital requirements, say, which would have been imposed regardless of the underlying risk. A multi-layered regulatory approach, then, is a "next-best solution"; and I am in no doubt that the banking community will be able to live comfortably with this situation after a period of transition.

The often-cited negative implications of regulation – that it tightens the credit supply and drives up administrative costs at credit institutions – should be analysed objectively. Viewed from a distance, it's possible to identify the myths and drill down to a kernel of constructive criticism. This kernel is what we need to give serious thought to – but blanket criticism would be unwarranted here.

One point of departure for simplifying matters might be a move towards greater proportionality in banking regulation, and by that, I mean the debate over whether it would make sense to introduce a more graduated set of rules for smaller, less risky institutions.

But why should we graduate regulation? Some claim that proportionality isn't necessary. After all, isn't complying with complex rules a costly and time-consuming exercise for institutions, whatever their size? But I would say that the costs of compliance weigh more heavily on smaller institutions, with their smaller workforces.

They essentially face two challenges simultaneously. First, the complex rules place strict demands on their operating business; second, smaller institutions have limited organisational capacities to cope with the legal, technical and operational requirements. Intricate sets of rules can cause particular duress for smaller institutions with limited capacities.

These considerations lead me to believe that we are right to consider whether, and how, rules can be tiered according to an institution's size. And that's why I wholeheartedly condone the proposal recently put forward by Finance Minister Wolfgang Schäuble and his UK counterpart George Osborne to review the relevant EU regulations – mainly the Capital

Requirements Regulation, but others as well. That review is lined up in the next two years. Apart from that, of course, we still have to implement the final Basel III elements in the EU, a topic I will touch upon later in my speech. We ought to make the most of these revisions of the EU regulations and explore whether a graduated set-up is feasible, and if so, what it would look like.

But – and this is a big but – at no point should financial stability be weakened. That's why any simplifications need to address the organisational and operational burden rather than the capital adequacy requirements.

5. Completing the reforms

After eight years of regulatory reform, there is a real danger that motivation to complete the reforms will wane. Memories of the financial crisis are fading, superseded by more pressing problems. We cannot afford to succumb to reform fatigue as we approach the final stretch.

When it comes to banking regulation and the impact of the reforms, we must therefore take a long-term rather than a short-term view. Please don't get me wrong: it is important that banks and savings banks remain profitable in the long term. But our focus, as regulators, is on stability – with a view to sustainable real economic growth. Again, the profitability of the banks plays an important role in this.

Let us not forget the repeated instances in the past in which credit bubbles have led to financial crises – and on each occasion we were told that "this time is different" and "this time it's not a bubble".[8] But every bubble has ended up bursting, and the costs have had to be socialised in most cases.

There is a simple but important truth in this: the reforms must be completed swiftly. This is the only way we can reduce the risk of future crises and ensure that those who are responsible for causing a financial crisis are the first to be held accountable for its costs.

With this in mind, the Basel Committee on Banking Supervision developed the new Basel III regulatory framework, which contains tougher capital requirements, a leverage ratio, new liquidity regulations and new macroprudential instruments. These rules were implemented in Europe as the CRD IV package and have been in force since 2014.

As I mentioned earlier, however, some major elements of the reform agenda are still missing. The Basel Committee is taking longer to consider how they will be completed. For instance, we plan to revise existing methods of measuring risk-weighted minimum capital ratios with a view to reducing the disparities in calculations for similar portfolios and the misuse of internal calculation methods. The regulations on market risk have already been established and the finalised version of the credit risk standardised approach will be published in the next few months.

At the moment, we are also discussing proposals relating to other areas, including the internal ratings-based approach for calculating credit risk, which we will continue to discuss with the banking industry until June. We plan to thoroughly overhaul this approach – portfolios that do not meet strict modelling requirements will be excluded from the IRB approach, the regulatory parameters will be fully revised and tightened in many cases, and capital floors will be introduced to ensure that minimum capital requirements do not fall below a certain level. These floors will be set according to the standardised approach.

In addition, the new standardised measurement approach for operational risk will be presented for consultation with the banking industry by the end of June. Among other things,

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[8] C M Reinhart & K S Rogoff (2008) This Time is Different. Eight Centuries of Financial Folly, Princeton.

it will replace the existing internal model-based method, meaning that, in future, there will no longer be an internal approach for measuring operational risk.

These revisions are far-reaching and necessary, and it is important that German banks and savings banks participate in the consultations by providing constructive suggestions. However, I would like to make one thing clear from the start: criticism of the fundamental concept will not achieve anything – the decision to limit the use of internal approaches has already been made.

At the same time, the final consultation on treating the leverage ratio as a Pillar 1 minimum capital requirement will continue until July. A key aspect here is that we want to introduce a surcharge for global systemically important institutions.

In addition to the Basel III reforms, the Basel Committee is also discussing the current practice of giving sovereign bonds privileged regulatory treatment. The Bundesbank is campaigning to require banks to hold sufficient capital against the risks of sovereign bonds and for exposures to sovereigns to be covered by the usual large exposure rules. However, these reforms will only be finalised after 2016.

6. Reforming business models

Ladies and gentlemen, rules must be developed, reviewed, accepted and implemented. Banks and savings banks will probably adapt their organisations in the very same way for years to come.

As a former banker myself, I can understand that these costly and challenging processes can be frustrating, especially for those working at banks that played little or no part in the excesses prior to the crisis.

But we must not forget that the processes in question are transitional and involve high one-off costs and greater compliance expenses in the long term. In the light of the important role of credit institutions in the economy, they are absolutely justified.

Many of the problems stem less from regulation but more from the fact that some institutions are still clinging to their old business models despite finding themselves in a new world. But the old world of unlimited financial markets has gone – for good.

Like many other European banks, some German institutions are still searching for business models that are competitive, viable, and yet sustainable. This is clear, among other things, from the fact that German credit institutions have the poorest cost-income ratio in the EU, and also lag behind in terms of other profitability ratios.

However, I won't pretend that finding the solution to this problem is simple. After all, profitability cannot and must not focus on the short term. That was, in fact, one of the causes of the most recent financial crisis. Sustainable business models must be well-conceived and must also enable banks to weather difficult phases. If credit institutions change their strategic focus as a result of the new rules, as we have actually already seen in a few cases, this is not necessarily a negative side effect of regulation or proof that the regulators have overshot their mark. It may actually be proof that the new regulation has achieved its aim – to encourage banks to adopt sustainable business models.

7. Conclusion

Ladies and gentlemen, since the 2008 global financial crisis, regulation has been significantly tightened all over the world.

Are the costs of regulation excessive? Without a doubt, they are significant. But if we analyse the costs and benefits to society, the outcome is clear: compared to the costs of a crisis, the costs of regulation are an appropriate price to pay for greater stability. And what is more,

effective regulation not only increases the stability of the financial system, it also encourages sustainable developments in the real economy.

On the whole, I believe we have been neither overregulating nor underregulating. It is now crucial to apply the rules that have already been adopted consistently and to complete the outstanding reforms promptly and comprehensively. The rest of the reforms are in the pipeline. They will be rigorous, but not excessively so. That's all there is to say. Credit institutions will have to get used to a new market environment and develop business models that are sustainable in the long term.

But we in the Basel Committee will make sure that, on average, the minimum capital requirements do not continue to rise above the level already reached. To do this, the Committee will insist that the overall burden of the reforms is analysed in advance and limited if necessary. Once the Basel III reforms have been finalised, it is also important to allow time for them to be implemented rather than immediately embarking on new reforms.

And I believe that we should check whether the rules could be simplified for smaller institutions. I therefore wholeheartedly back the proposals to review the EU framework by the German finance minister, Wolfgang Schäuble, and the British finance minister.

Credit institutions must be regulated. But regulation cannot succeed without credit institutions. Without the tireless efforts of the banks and savings banks, the banking and financial system will not improve. They have already gone to extraordinary lengths over the last eight years, and that must be rewarded. However, we have not yet reached the end of this long and winding road. Let's continue to travel together in the future.

I now look forward to discussing with you what the path ahead might look like. Thank you very much for your attention.