View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Research Papers in Economics

Panel 3

Banking Regulation

Keynote Address by

Axel Weber
President of the Deutsche Bundesbank

The financial crisis, though in its third year now, still presents us with a great many challenges. Nevertheless, while the number of challenges has not decreased, their nature has changed. With the stabilisation of markets and the onset of recovery, the focus has shifted from managing the current crisis to preventing future crises. And a cornerstone of this attempt to create a more stable financial system is the reform of banking regulation. As the field of banking regulation is highly complex and involves a host of technical details, I will limit myself to a brief overview of the current state of the reform process, highlighting some critical points. However, I am sure that the ensuing panel discussion will provide us with an opportunity to elaborate on some of the more technical details.

Micro- and macroprudential aspects of regulation

Any attempt to create a more stable financial system should begin with the individual bank – that is, on the microprudential level of regulation. The relevant regulatory framework on this level are the Basel II rules, which have been implemented by a large number of countries. As the crisis revealed some shortcomings of the Basel II framework, the G20 commissioned the Financial Stability Board to work towards a reform of the current rules. A first set of relevant measures was published in the summer of 2009 as a direct reaction to the subprime crisis.

Among others, these measures include stricter capital requirements for market risk and securitisation as well as heightened risk management requirements. Additional proposals were put forward in December 2009. Aiming at enhancing the resilience of the banking sector, major elements of these proposals include a new liquidity standard as well as a revised definition of capital. In the course of the current year, the relevant measures will be calibrated on the basis of a comprehensive impact study and be finalised by the end of 2010.

Although the envisaged reforms will strengthen the existing rules, they will not change their underlying principles. In essence, the Basel II framework seeks to limit banks' risk-taking behaviour by making it more expensive and thus less attractive. Against this backdrop, recent proposals to prohibit certain risky activities altogether pursue a more radical course.

One fundamental problem of such an approach is that the complete prohibition of certain activities is a very far-reaching market intervention, especially since these activities do not necessarily have zero economic value-added. Contrary to the Basel II approach, the penalty imposed on risky activities would become infinite. Thus, given the inherent trade-off between the efficiency costs of intervention and its benefits, a reformed Basel II framework might provide a more balanced solution.

This is also the case with regard to the introduction of an additional tax for the banking sector. Even though such a tax could be useful in recouping some of the costs of the crisis, it is an inferior instrument in terms of internalising the effects of risky activities on financial stability. Hence, the reform of the Basel II framework is rightly given preference by regulators and should be implemented with priority by policymakers.

International cooperation and harmonisation

Another factor that increases the complexity of the reform process is the need for international cooperation in order to move to a regulatory level playing-field. Due to the ongoing process of globalisation and the emergence of internationally active banks, international harmonisation of regulation has

become essential in safeguarding the stability of the financial system. The general case for a stronger harmonisation of regulation could be made by imagining a globalised and interconnected world where national rules prevail. In such an environment, internationally organised banks could easily avoid national regulations by shifting business activities across borders. Via this process of regulatory arbitrage they would be able to comply only with the lowest standards and thus endanger the stability of the financial system. At the same time, this behaviour would put those banks at a disadvantage which are not internationally organised. A level playing-field as the basis for fair competition would not exist. Furthermore, nationally fragmented regulatory frameworks would hamper cooperation between home and host supervisors of international banks and thus lower the effectiveness of regulation. Hence, attempts to put the reform of regulatory frameworks on an international footing are fully warranted, even though this adds an additional layer of complexity to the process.

Conclusion

The financial crisis has taught us three very broad lessons. We have to strengthen regulation on the microprudential level, complement it with macroprudential supervision and ensure international harmonisation and cooperation. Although we have already come a good distance, we have to sustain the political will to stay the course. As we are now hopefully entering better times, there is a certain danger that some major issues on the reform agenda might fall prey to dwindling commitment and political interests. However, this must not be allowed to happen, as only a coordinated and harmonised effort will enable us to ensure financial stability and thus pave the way for steady and sustainable global development.

Panel

Anatole Kaletsky, Editor-at-Large of *The Times* and panel chairman, reflecting on the Greek debacle and its then unpredictable consequences for the euro, quipped that the conference title now could well have been 'The Financial Precipice: The Step Forward'. Or the step back, on second thought. He then pointed out that we have gone from a financial crisis in which the banks threatened the solvency of governments to one in which governments threaten the solvency of banks. And, while confident that Greece would be rescued, he wondered whether that would turn out to be the last possible rescue that was fiscally feasible. In that case, "Greece could be the Bear-Stearns of this particular crisis, so the question is what is going to be the next Lehman Brothers?"

With this he gave the floor to **Markus Brunnermeier,** a professor of economics at Princeton, who provided the academic introduction to the regulation issue. Echoing Bundesbank Axel Weber (see previous pages), he pointed out that current regulation is characterised by a micro-prudential approach, in which the risks of financial institutions are considered in isolation, but that future regulation should complement this and be macro-prudential in focus, centring on spillover effects between institutions. These spillover effects can arise both directly (through contractual channels) as well as indirectly (through price channels). For example, in times of crisis, fire-sales depress prices, leading to higher margins and haircuts; higher margins and haircuts, in turn, depress prices further, eroding the wealth of the whole financial sector. Thus, he added, there are three considerations to keep in mind for constructing a macro-prudential regulatory framework. First, existing risk measures, such as Value-at-Risk (VaR), should be replaced with new systemic risk measures like CoVaR, i.e. the VaR of the financial system conditional on institutions that are under distress. These systemic measures should also form the basis for calculating the tax base of any new bank tax. Second, regulation should be countercyclical to reflect the fact that, during the expansionary phase of a credit bubble, risk generally builds up in the background even while volatility is low. And, finally, to adequately regulate the shadow banking system, regulation should include not only financial institutions but also financial instruments.

The first panel speaker was **Robert Kimmitt** of the Deloitte Center for Cross-Border Investment. He called attention to the growing involvement of governments in the business of business, not only as a market participant, but even as owner, pointing out that decisions that matter are increasingly being

made at the intersection where business, finance and government meet. Acknowledging the efforts of the US Congress and the G20 to devise legislation and regulations for the financial system, he harboured the hope that "the key will be a continued effort to strike a balance between prudential regulation and market discipline". If regulation is tilted too far away from the markets, he warned, it could stifle the innovation and entrepreneurship needed for economic growth. He also drew attention to a frequently overlooked aspect: an enforcement agenda. In his opinion, it is going to be very difficult politically to come to agreement in the United States, Europe and elsewhere on this. Still, Kimmitt said, "my personal view is that the new financial services regulatory regime that will emerge in the United States and Europe will be more burdensome, costlier, but ultimately manageable for institutions". Finally, he stressed that it is important to continue this dialogue among business, finance and government on a regular basis, not just in times of crisis.

He was followed by **Takamasa Hisada** of the Bank of Japan, who expressed his worries that arguments on the regulatory reforms are focusing too much on capital and liquidity, and less on risks or risk measurements. Capital sufficiency, he said, cannot be appropriately judged unless risks are accurately captured by banks. He also remarked that the capital buffer and the liquidity buffer are not independent in terms of reducing a bank's probability of default. For that reason, he hopes that the Basel Committee and financial authorities in each country will carefully assess the impact of the regulatory reforms and propose a well balanced set of regulations. Timing for the introduction of new regulations is also paramount: a hasty introduction could impair the current economic recovery and may risk a double dip. Finally, Hisada emphasised the importance of country-specific regulatory frameworks that take into account each country's particular financial structure and economic conditions. He believes banking regulation alone cannot secure financial stability or avoid the recurrence of a crisis. Supervision is also important, as is a so-called macro-prudential policy.

The next speaker was **Leszek Balcerowicz** of the Warsaw School of Economics. He focused on how to reduce the incidence of serious financial crises, in particular on how to constrain the growth of booms which, when burst, inflict serious losses in the financial sector, and how to limit the 'transposition' of these losses into negative shocks to the real economy. He compared the former task to the introduction of car speed limits, and the latter to the introduction of safety belts and other safety equipment in the cars. The crucial thing is that this must be achieved in a cost-effective way. This rules out measures that would reduce the risk of such crises but at the cost of stifling the capacity of the financial sector to finance growth-enhancing projects. Most important, however, is to eliminate those policies that have contributed to the financial crisis, such as state-directed credit allocation, persistently expansionary fiscal policies, tax regulations that favour debt financing relative to equity finance, subsidies to mortgage borrowing, financial regulations that encourage excessive securitization, and generous deposit insurance, since it eliminates an important source of market discipline, to name but a few. In other words, care must be exercised to identify those components which enhance risk-taking in the financial sector by crowding-out market discipline or by subsidizing risk-taking, as well as those that enhance the credit and asset booms.

The last speaker was **Karolina Ekholm** of Sweden's Central Bank. From the Swedish perspective, today's financial crisis feels like "we've been there". The silver lining that comes with a crisis is that it does create momentum for reform. Now Sweden is considered as a good example when it comes to public finances, and that is a consequence of the reforms that Sweden was compelled to put in place in the mid-1990s. But the momentum that you get in a crisis does not last very long: "now we have a window of opportunity to enact the reforms to make the financial sector more resilient, but I worry that we have to move relatively fast". The Swedish experience is that once the crisis of the 1990s waned, some of the draft proposals written up were just put away, not being dusted off until the early stages of this crisis. There are lots of proposals now on the table. "I want to focus onto something that has not been talked so much about yet: the issue of how to deal with distressed banks. A problem bank must be handled extremely quickly, otherwise confidence will be lost. For this reason, it is necessary to be clear *ex ante* how we are going to act". In this respect, cross-border banks in distress are a particu-

larly difficult case, and the question of how to deal with them causes specific problems. But, she warned, it would be a pity if as a consequence of such difficulties in dealing with cross-border banks international financial integration were to be rolled back. "Therefore, we need legally binding international agreements that will regulate the principles for burden-sharing of crisis resolution costs between countries", she concluded.