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Banking Regulation

Keynote Speech

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1 Introduction

Ladies and gentlemen

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.

2 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

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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.

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Regardless of its actual design, the general objective of regulation on the microprudential level is to have a first line of defence by reducing the likelihood of individual bank failures. However, given our globalised and interconnected world and the interdependence of financial institutions and markets, even the failure of a single institution might lead to systemic disruptions. Thus, it is necessary to complement a strengthened microprudential regulation with a macroprudential stance which as a second line of defence takes into account the stability of the financial system as a whole. One major aspect of macroprudential regulation would be the treatment of systemically important financial institutions. Although the revised Basel II framework is part of a solution to this problem, broader reforms are necessary. These might include capital surcharges for systemically important institutions, better resolution regimes as well as a stronger market infrastructure.

Regarding the reform process itself, we have to bear in mind that the decisions we are about to make will shape the global financial system for years to come. Thus, accuracy is more important than speed, and we have to be careful not to implement oversimplistic solutions. Regarding the required complexity of regulatory measures, potential interactions have to be taken into account, as otherwise the danger of unintended consequences will grow. At the same time, the cumulative effect of new measures has to be considered, which makes thorough impact assessments of the intended consequences necessary. We are, of course, aware of the fact that a slow pace of reform increases regulatory uncertainty for market participants. But up to now, policy development has proceeded according to agreed and very ambitious timelines, reducing the uncertainty as far as possible.

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3 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.

4 Conclusion

Ladies and gentlemen

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

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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.

Thank you for your attention.

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