Andreas Dombret: Too little, too much, or just right? Reforming banking regulation after the financial crisis

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 21st Colloquium of the Institute for Banking and Financial History (IBF) "Ways to a stable financial system", Frankfurt am Main, 23 November 2017.

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1. Ways to a stable financial system

Ladies and gentlemen

You have heard numerous speeches today on proposals for reforms and their pros and cons. Now I think it's time to briefly revisit our actual objective. And this is "Ways to a stable financial system".

Scholars, politicians and regulators have been racking their brains over this problem since 2007, the year the financial crisis broke out. The question of whether a financial system can even be stable in the first place has also emerged. And yet if there is one thing we all know, it is that there will never be a completely stable, completely crisis-proof financial system in the real world.

However, we are all here today at this colloquium out of the conviction that, if nothing else, a financial system can be made a little less vulnerable, thereby containing the fallout from crises – provided the right solutions are found.

The G20 countries have travelled a long and often rocky road in order to make the financial system more stable. I have been following this path from my perch at the Bundesbanksince 2010 – I started out originally responsible for financial stability and, since 2014, have been in charge of banking and financial supervision.

And I, too, have been asking myself time and again: have we taken the right road? Or have we fallen short? Have we possibly gone too far in some places, or even gone entirely off track?

The answer to these questions, sadly, is not that simple – and that is why it has been occupying us to this day. Still, I would like to attempt to deliver an answer, based on three points.

I initially wish to discuss the regulatory principle that was supposed to guide post-crisis reforms: if we assume that the idea of a 100 % stable financial system is utopian, then reforms should be conducted to prevent financial bubbles from being created by misvaluation and excessive leverage while crisis-proofing banks.

My second point concerns equilibrium and an assessment of these reforms. As a supervisor and regulator, I am naturally partial and convinced that we have taken the path of the golden mean: in my assessment, financial stability and risk appetite are being treated equally. And this is why, once Basel III has been finalised, we should take a regulatory break for now.

Yet – and this is my third point – reforms will have the desired effect if, and only if, the rules are also credibly and rigorously implemented and applied.

2. Prevent the build-up of bubbles and make banks crisis-proof

Let us begin with the question as to the right guiding principle for regulation. As long ago as 1986, economist Hyman Minsky formulated one avenue worth exploring in his book Stabilising an unstable economy, a book which remained largely obscure for 20 years – and thus long past his death in 1991. It was only the 2008 crisis which revealed the importance of his theses to all.[1]

Minsky saw financial markets as having a natural inclination towards instability and crisis. That was wholly out of kilter with the then-prevailing zeitgeist – and the blossoming financial markets of the period. Nor, by the same token, did it go along with the prevailing theory in economics – the efficient markets hypothesis.

From today's perspective, we know that financial markets have a tendency to exaggerate and thus experience cyclical instability. Minsky was far from along in noticing this. His decisive discovery, however, was that this instability has its origins in stability – more precisely, in a period of stability which encourages increasingly excessive risk taking.

What do I mean by that? Long periods of growth lead to exceptionally favourable funding terms; these, in turn, encourage enterprises and households to make investments that are based to a very great extent on the principle of hope – hope that the economy will continue to grow at the same pace. Banks prop up this optimism by easing the terms and conditions for their lending and later even lowering their credit standards. This all adds up to burgeoning debt, which is sustainable only as long as debt can be serviced.

However, once it is no longer possible to service this debt, and asset values subsequently fall, what is known as a "Minsky moment" occurs. That is, debt becomes unsustainable, materialising when positive expectations give way to pessimism. A subsequent cascade of financial price corrections and defaults causes losses to the real economy.

One of the decisive things we can learn from this is that financial crises and their causes are an integral part of the system. And, like with any system, the disrupting factors are already built into the financial system.

So what does Minsky mean in terms of banking and financial regulation? In any case, it doesn't mean sitting around and twiddling one's thumbs. Although Minsky explains how financial crises occur, the cause and effect relationship he describes is not a law of nature. Far more important is that regulators and supervisors understand these interrelationships and use the instruments at their disposal to reduce the likelihood of a "Minsky moment" occurring.

Minsky has therefore tendered a guiding principle for discussion: if regulators develop new rules, they have to ensure that the build-up of a bubble through excessive credit growth is less likely than it would be in a wholly unregulated financial market with an inclination towards exaggeration. However, since no regulation, however forward-looking it might be, can completely prevent crises altogether, banks have to be crisis-proofed.

As I said, Minsky's theory has been around for over 20 years. Yet guiding principles – as we all know – do not automatically translate into optimal regulation. Real regulatory initiatives need a little more actual content.

This has been a matter for policymakers and supervisors in equal measure since 2008. The second point I will discuss is how well they have performed.

3. Reform after the financial crisis: too little, too much or just right?

This morning, my colleague on the Bundesbank Executive Board, Carl-Ludwig Thiele, already gave an account at this colloquium of the major cornerstones of the reforms after the financial crisis. I shall now flesh that out by naming the latest developments: in the case of the Basel III reform, a compromise is within reach. At the technical level, negotiations have already been concluded. With the completion of Basel III, the G20's reform agenda will have essentially been fulfilled.

The question of whether this puts us on a path towards a stable financial system is not one that I am going to answer by citing individual regulatory clauses or percentages, but with a general

evaluation.

The objective of good regulation is and has always been to prevent economic bubbles from forming as far as this is possible and – if a crisis is unavoidable – to limit its impact on the general public and the economy. It is just that therein lies the major challenge: what is the correct measure? What constitutes a proportionate intervention? What regulations are appropriate and which are disproportionate?

As I have already explained, I firmly believe that we have embarked on an effective and, at the same time, balanced path over the past few years. The reform packages are making banks significantly safer: as a result of more stringent capital requirements, by the introduction of the leverage ratio, by the introduction of not one but two liquidity minimum requirements, by the introduction of capital buffers and by further elements.

More than that: we are also tackling the problem of bubble formation. Through prudential requirements and through stress tests, for example, institutions are being placed under an obligation to conduct a more cautious risk management at an early stage. There has also been a microprudential upgrade, say, as a result of stricter requirements for systemically important institutions and instruments designed to prevent the emergence of bubbles – think, for example, of possible cyclical capital add-ons for mortgage loans.

And, not least, the creation of the banking union has very much strengthened regulation and supervision of the financial system in the euro area.

In total, the reforms have all been concerned with restoring the equilibrium of the market economy. You can tell that, in particular, by an additional, quite important new instrument – the way in which bank distress is treated. During the financial crisis, there were a number of bank rescues. Mr Thiele has already referred to this “fall of the market economy”.

A resolution regime has now been established in Europe. The failure of a major Spanish institution five months ago demonstrated that the rules work and that investors can indeed be bailed in. Other, less satisfactory cases have shown, however, that gaps still exist, and these have to be closed. All things considered, I nevertheless regard the reforms as important instruments with which the fall-out and costs of financial crises can be distributed more fairly among those responsible.

You can see, therefore, that we are not relying on a single solitary instrument or a single solitary approach – rather, we have a toolbox with complementary instruments. In total, this toolbox – I firmly believe – makes our financial system much more stable.

Other proposals presented today go even further. Their common denominator, however, is that the causes of the financial crisis can supposedly be eliminated only by even more radical approaches.

I think that such a debate is very important: in my opinion, scholars have a downright duty to look beyond their own field, to question old approaches and develop bold new ones.

For that reason, too, I shall not be going into detail about the pros and cons of these alternative approaches. My point is a more general one: the advantage of a far-reaching, fundamentally novel approach may also be its inherent drawback. While offering new solutions, it also creates new problems – problems that are mostly unidentifiable on the drawing board.

Seen in that light, a comparison between an existing system and a radically new one is always flawed: with the existing system, the focus is on the real problems, while the new approach directs attention to improvements that are full of promise. Because the new approach has not yet undergone a reality check, it virtually almost always looks like the better option. But its

implementation in terms of actual regulations may bring serious, unintended side effects for our financial system in its wake.

It is also extremely important to me that we take into account the fact that regulation can, indeed, go too far – that is to say when there is formed the illusion that a perfect, stable financial world can be created and the zeal for reform restricts economic activity to such an extent that innovation is choked off and economic upturns are stifled.

But, sadly, unintended side effects of reforms can indeed lead to the obstruction of key functions, the unnecessary break-up of beneficial, established structures, and the unpredictable frustration of wealth creation. Sustained economic growth needs innovation and risk taking, however: a failure to safeguard the supply of credit to economy can enfeeble economic activity.

I perceive such a threat in the calls for making banking regulation even more stringent. As much as I can understand the motivation behind them, I have immense appreciation of the accompanying effects of turning the screws too tightly when it comes to regulation.

Anyone wanting to live in a completely risk-free world would therefore also have to accept much less dynamic economic growth.

There is another point that seems important to me: regulation can create inadvertent effects on the structure of the financial sector. Applying regulations adopted for the large banks with an international focus one-to-one to smaller institutions clearly places those small institutions at a disadvantage. That is why I advocate lowering the regulatory burden for the small, low-risk institutions that do not operate internationally.

In summary, I take a positive view overall of the post-crisis reforms that will soon be completed. Taking this compromise as a starting point, we now have to look to the future – for it is well known that the challenges for the banking sector are considerable. With regard to regulations, we must not give in to those who want to turn back the regulatory clock. But nor we must not go on tightening the screws of regulation ever further.

I am therefore in favour of a regulatory break after the reforms have been completed. This should be used to thoroughly evaluate the impact of the reforms and to amend and improve them where gaps and errors are found. This does not include the few outstanding areas where action is called for, such as the regulatory treatment of government bonds.

4. Paper never refused ink: reforms will be short-lived without a change in attitude

Ladies and gentlemen, as you can tell, I am a realist. And that brings me to the third point I would like to make – that even the best reforms will only go so far if they are not accompanied by a permanent change in attitude.

Because without that change, the rules will be monitored less rigorously than intended. Even before the diesel scandal broke, we knew that even the best rules don’t achieve much if nobody is made to keep them.

Ideally, the change in attitude in the financial sector should be based around an understanding that consistently monitoring and complying with the rules is in everyone’s interests. All too often, decision-makers think that they are doing the economy a favour by saving a bank from insolvency or calling for prudential leniency in order to prolong a riskier type of activity. Their intention, one would imagine, is to safeguard stability and jobs – but unfortunately, it has often turned out to be an unrealistic one.

Instead, all that such leniency has done is make two things more likely in the medium term: financial market bubbles and economic stagnation.

That's because the financial crisis was the outcome not just of a handful of undisciplined banks or gaps in the rules but also of the belief that light-touch interpretation and monitoring of the rules was promoting economic activity. As you can see, political beliefs influence how rules are applied – and there is now even clear, international evidence to confirm this view.[2]

And yet some people keep slipping back into the old ways of thinking. The debate about deregulation in the US springs to mind, for example, as does the discussion about non-performing loans – here, at times, it seems that, for some decision-makers, things can't progress slowly and gently enough when it comes to tackling these long-standing and serious problems. The debate about competitive deregulation after Brexit suggests that the old mindset might be making a comeback.

The more important, then, to grasp that the reforms being discussed today will only actually prevent bubbles from forming and strengthen banks if the rules are applied consistently and effectively.

Those who go easy on or even rescue a sickly bank by interpreting the rules generously are eroding the substance of our economy. They are deactivating the market economy principle of competition, enfeebling innovative potential in the banking sector and, if anything, helping to prop up "zombie banks" whose days would be numbered were it not for the light-touch approach. Indulging a credit institution and its creditors ultimately comes at the cost of economic growth.

Financial history repeats itself, too, so we need to rigorously implement the reforms we have agreed upon. But what does the change in attitude I am talking about mean for prudential decisions on the ground?

To be clear, most prudential decisions are made within the established legal framework, which the reforms undertaken have made far more tight-knit and robust.

Decisions where the rules are not entirely clear-cut – that is, where discretion can be applied – might pose difficulties. And this is where the change in attitude comes into play. Today, we know that supervisors need to weigh up between reducing the likelihood of a bubble forming or permitting low-yielding but relatively risky activity. As I see it, they must have the courage and confidence in this situation to do what is best for financial stability – and then be bold enough to face the music – even if it later transpires that one or the other decision went overboard. Because decisions that are geared to preserving stability are generally better for the economy as a whole.

To put this principle into practice, decision-makers will also have to make uncomfortable decisions – such as winding up a bank with a bail-in of investors, imposing capital add-ons, or restricting the distribution of dividends if an institution fails to comply with the buffer requirements.

I would like to remind you again of the balancing act between preventing bubbles from forming on the one hand, but not stunting economic growth on the other. This feat is something which regulators and supervisors need to take very seriously at all times. For the vast majority of decisions, it would be very wrong for us to act like supervisory sheriffs, clamping down on useful financial intermediation. We need to focus on the decisions that really count – with prudence, expertise and determination.

Specifically, this means that the change in attitude, which can be seen in the post-crisis reforms and elsewhere, needs to be embraced once and for all – by supervisory authorities as well as political decision-makers. Not only do supervisors need to have the tools to intervene; they also have to be confident enough to use them. And it would be wrong for that confidence to be undermined by incentives to shield banks. Policymakers, then, would do well to respect the professional independence of authorities and the objective decisions they make. Conversely, this means that they must refrain from applying pressure on authorities for political reasons.

5. Conclusion

We have made considerable progress since the financial crisis erupted. The banking and financial system is a great deal better off these days. We have created a toolkit to make future crises less likely and make institutions more resilient to withstand any turbulence that does occur. Banks have more capital, and they are managing their risks better.

But there is a danger that even the best regulation will remain piecemeal if its rules are not applied consistently. Only the rigorous and consistent supervision of credit institutions can ensure that bubbles are less likely to form and that, in an emergency, there is enough capital to absorb losses.

When it comes to applying the rules in future, we should heed Minsky's key message, which is that, for all their undeniable merits, financial markets do always have a tendency to form bubbles and thus slip into financial crises; also, that these bubbles build up in upbeat economic spells – which is when nobody wants to talk about it.

To stall the formation of bubbles and to equip banks to cope with headwinds, supervisors and policymakers need to evaluate the impact on society as a whole. But this will only happen if the change in attitude takes hold among policymakers and supervisors. Let us hope that today's conference will help make this happen.

Thank you for your attention.

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[1] HP Minsky (1986) Stabilizing an unstable economy. New Haven: Yale University Press.

[2] Barth, J R, Caprio, G & Levine, D S (2012), Guardians of Finance. Making Regulators Work for Us, MIT Press, Cambridge.