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Firm as a rock – is bank capital an all-purpose tool?

The example of sovereign debt regulation

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1 Introduction

Ladies and Gentlemen

Thank you for giving me this opportunity to speak at Columbia University. It is a pleasure to be here again. It is always inspiring to participate in such an academic environment. I was here three years ago and fondly remember talking to students.

When I was here last in November 2012, I talked about the crisis in the euro area. At that time, the topic was a good pick. Since then, much has happened in terms of regulatory and supervisory reform in Europe. One prominent example is the creation of the European Banking Union, which aims to introduce a supranational perspective into European supervision. We have, since November 4, 2014, created a Single Supervisory Mechanism and the

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Single Resolution Mechanism will follow in less than a month. The ECB here assumed responsibility for supervising – in cooperation with national supervisors – about 120 largest banks in the euro area. These banks account for more than 85% of the aggregate balance sheet of the euro area's banking sector, making the ECB one of the biggest banking supervisors in the world. The Bundesbank very much supports this development.

Ladies and gentlemen, one prominent Columbian, as you call yourselves, was Theodore Roosevelt. He once said: "In any moment of decision, the best thing you can do is the right thing, the next best thing is the wrong thing, and the worst thing you can do is nothing."

For regulators, the crisis definitely constituted that moment of decision. And for sure we cannot be criticised for doing nothing. Time will tell whether we did the best – i.e. the right – thing. For my part, I am convinced that we did many things that were both worthwhile and right.

2 Different traditions, but…

When you think of financial crises, one of the first ideas that come to mind is the need to make banks more resilient. And one key factor in enhancing the resilience of banks is to strengthen their capital base. I will return to this point later on.

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When talking about capital and credit, it is quite obvious that there are different traditions in the United States and in Europe. While financing in Europe – with the exception of the United Kingdom – is still predominantly bank-based, the US tradition is much more market-based. Economists have debated which system is superior for decades, if not for centuries [1].

This is neither the time nor the place to repeat the whole debate about advantages and disadvantages of the respective systems. Allow me, however, just to name some significant points of the discussion. There is empirical evidence to suggest that market-based systems react more procyclically than bank-based economies because of more pronounced asset price booms and busts [2]. However, bank-based systems are also beset by procyclicality. A study conducted by the Bank for International Settlements has shown that, while bank-based systems are more effective at smoothing the impact of business cycle fluctuations, market-based economies recover more quickly after crises [3].

Leaving aside the pros and cons of the two systems, it is my strong belief that the question of the proper financing source cannot be answered with “either/or” but has to be “both”. In the end, it comes down to the uncontested argument of diversification. And the answer is highly dependent on the context. In Europe for instance, the bank-based system reflects the corporate structure of the economy – there are many small and medium-sized entities, the so called SMEs. And – like in the United States – the SMEs tend to favour bank-based financing, if only as necessity because there are barriers for small companies to obtain market financing.

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Against this backdrop, I very much appreciate the European Commission's efforts to establish a European Capital Markets Union. By making it easier for small and medium-sized enterprises to access the capital markets, we could open up a further source of funding for them. To make one point clear: Referring to what I said before about "either/or", the objective of the European Capital Markets Union is not to abandon bank-based funding but to supplement it with capital markets-based funding. And in Europe of all places there is plenty of scope to do so. The European stock market is only 60% of the size of the US stock market as measured in relation to GDP. Similarly, the European market for venture capital is 20% of the size of the US market, and for securitisation the percentage is even lower still [4].

3 … capital matters: regulatory reform after the financial crisis

Although we represent different financing systems, one point is essential for both. Capital is a main starting point for safeguarding the strength of banks as well as financial stability. Resilient capital markets need resilient banks as key players in the financial system. And resilient banks need capital – or rather equity – in order to be able to absorb negative shocks. And this is where regulation comes into play.

One of the main lessons of the financial crisis was that the rules governing the banking system were insufficient. We saw excessive risk-taking, insufficient loss-absorbing capacity and banks that were "too big to fail" – to name just a few of the problems that led us into the crisis.

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Over the seven years since the collapse of Lehman Brothers, significant progress has been made on the regulatory agenda. The most important regulatory measure was the Basel III framework, which introduced stricter capital requirements and new liquidity rules. In the EU, CRD IV and CRR, the relevant directive and regulation, ensure harmonised implementation of the Basel III framework across all member states.

When Basel III is fully implemented in 2019, regulatory capital requirements will be significantly higher and capital will be of higher quality than under Basel II, and I am convinced that the financial system will be much more stable than before. The calculation is quite simple: More equity that can absorb losses makes banks safer. Besides, more equity on the one hand strengthens the interest of the bank owners in good risk management and on the other hand reduces possible losses of debt holders should the bank be faced with default.

4 Capital is not the panacea – the example of sovereign debt regulation

But are higher capital and liquidity requirements enough? Certainly not. And therefore, many other regulatory projects besides the Basel III regime have been tackled in response to the financial crisis. Let me discuss one example that I believe to be a very good illustration of the limits of capital as an all-purpose tool: The regulation of sovereign exposures.

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A problem that unfortunately became apparent during the European sovereign debt crisis was the close nexus between states and banks. Under the current regime, banks do not need to hold capital against the risks associated with loans to sovereigns – unlike any other loans. This is based on the assumption that loans to governments are risk-free because states cannot default, rendering capital buffers unnecessary.

All those who had trouble following this line of risk-free-debt argument saw their doubts confirmed by the sovereign debt crisis in Europe. It became obvious that we need to rethink the assumption that loans to governments are risk-free. In actual fact, sovereign risk is a cluster risk because the default of a sovereign as single debtor can well cause bank insolvency. Given the amount of home country sovereign debt that some banks hold – which sometimes exceeds their equity – a possible restructuring of sovereign debt may well threaten a whole national banking system.

Consequently, changing the rules appears imperative. If banks were required to hold capital against the risks of their government bond portfolios, they would be more resilient to fiscal distress. At the same time, banks would have less incentive to buy large volumes of government bonds if these were not privileged any longer. Furthermore, this may incentivise governments to reduce their debt. [5]

And this brings us to the second issue: Capital alone is simply not sufficient. A crucial tool in risk management is diversification – as specified in the Basel large exposure regime published in 2014 which will take effect from 1 January 2019. Large exposure caps prevent banks from becoming overexposed

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to a single borrower and the risk of its default. Currently, the regime is restricted to private borrowers, and sovereign bonds do not fall into its scope. To me, it is important to end this privilege and to create a level-playing field for private and sovereign borrowers alike. Therefore, a cap on loans to an individual sovereign is needed and should also be introduced.

Let me be very clear on this issue: Actually, I see no economic argument why banks should be the main source of funding for governments. Unlike relations with private borrowers – where banks have significant informational advantages compared to other creditors – there is no privileged information on the debt of a nation. As a consequence, I fail to see the reason why the financing of states should not mainly be a matter for the capital markets.

And I very much welcome the international community's efforts to tackle this topic: this summer, the G7 *finance ministers* and central bank governors identified the regulatory treatment of sovereign debt as a major topic to work on.

Also, the Basel Committee on Banking Supervision has been working on sovereign debt for almost a year now. I believe the following points to be crucial and I hope they will be addressed by the Committee next year [6].

• First, as I argued before, the large exposures regime should also apply to sovereign debts.

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• Second, the zero-weighting of sovereign exposures should be replaced by risk adequate weights and capital requirements. The calibration needs to be careful, and an appropriate phasing-in needs to be implemented.

• Third, and I find this equally important, regulation of sovereign exposures must be consistent for all credit institutions.

If we succeed in establishing a regulation consisting of these three points, I see four main benefits. First, if sovereign bonds needed risk adequate capital requirements, banks would have to take greater account of differences in the risk profiles of states. Second, countries that burden their budget in an unsustainable manner would have to pay risk premiums – this is the so-called disciplinary force of financial markets. Third, a large exposure regime applied to sovereign bonds would prevent banks from being overexposed to a single borrower. Related to that, the fourth last benefit, and this is of high importance to me as a banking supervisor – a sovereign debt restructuring would not any longer harm the whole financial system of a nation state and beyond.

The regulation of sovereign debt is one topic we must centre our attention on in the nearest future. I am cautiously optimistic that we will come to a transatlantic solution in the Basel Committee. In this context, I cannot say often enough that each regulatory project – be it Basel III or now the regulation of sovereign exposures – very much calls for international cooperation. If we do not coordinate our approaches towards regulation, we will create a fragmented financial system with vast opportunities for regulatory arbitrage. This cannot be our goal, and we need to resist any temptation of doing so.

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When all is said and done, we all have the same objective: a stable financial system – of course at the national level, but it is equally important at the global level. What we have learned in the recent years is that financial distress doesn't stop at national borders. In the euro zone we have experienced the hard way that instabilities even in small member states have the potential to put the continuance of the entire European Monetary Union at risk.

I would like, if I may, to say a few words about yesterday's decision by the ECB Governing Council. First things first: the Eurosystem staff macroeconomic projections presented give no cause for concern over the development of the euro-area economy. In fact, they confirm the view that the steep drop in energy prices is supporting the recovery of the euro area's economy. The lower energy prices also go a long way towards explaining the expected evolution of consumer price inflation.

It's clear that inflation as forecast by the Eurosystem staff will fall short of the Governing Council's price stability target not only in 2016 but probably into 2017 as well. That's not something we should simply brush aside. But given the predominant role which the drop in energy prices plays in euro-area inflation and the extensive monetary policy measures that have already been taken – which can entail risks and side-effects of their own – I am not really convinced that a further easing of monetary conditions was necessary.

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5 Conclusion

Ladies and gentlemen, since the beginning of the financial crisis, regulators have done a lot of work and thereby followed the instruction given by Theodore Roosevelt. Do you remember? – “In any moment of decision, the best thing you can do is the right thing, the next best thing is the wrong thing, and the worst thing you can do is nothing.” And I believe doing nothing and expecting the markets to recover on their own would not have been an option.

I am sure that the financial system is now safer and more resilient than it was before Lehman collapsed. I do not deny that stricter regulation may translate into higher costs for banks. However, when measured against the burden that financial crises place on society, I consider these costs to be very much justified.

The post-crisis reforms are in large part finished, but some regulatory projects remain on the agenda. I strongly argue for finishing the Basel III regulatory projects by end-2016 and afterwards give them the time to take effect. The regulation of sovereign exposures is a prime example for outstanding regulatory projects. But even if we strike an agreement on this topic regulatory reform will never be complete because the financial system is evolving constantly and regulation has to keep pace. So this means that we will have to follow Theodore Roosevelt’s advice once more when he said: “Get action. Seize the moment. Man was never intended to become an oyster.”

Thank you for your attention.

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