DEUTSCHE BUNDESBANK
EUROSYSTEM

Dr. Klaus-Dieter Geisler

Deputy Head

International Financial System Division

Deutsche Bundesbank

"Global Financial Crisis and Regulatory Reform"

Statement
at the Conference
"Enhancing Regional Financial Cooperation in Southern Africa against the Backdrop of the Global Financial Crisis"

Pretoria, South African Reserve Bank, 27 May 2009

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I Introduction

The financial crisis is far from over. Despite some encouraging signs, crisis management is still the order of the day in some places. In this respect, our immediate tasks are twofold. Firstly, we have to restore the functioning of the international financial system. On some occasions, resolute decisions are indispensable for solving problems of liquidity and solvency. The problem of toxic assets is still being worked out. Financial system rescue packages have been coordinated and are being implemented at the national and international level.

Secondly, economic growth needs to be put back on track. Fiscal and monetary policy stimuli are in place in many countries and are now starting to take effect. Reviving world trade and investment is essential. And, we must not repeat the historical mistakes of protectionism. We have to refrain from raising new barriers to trade in goods and services and, in particular, we must not retreat into measures that constrain worldwide capital flows, especially those to developing countries.

However, simply restoring of financial system functionality and economic growth will not be enough. As the financial system has not delivered the stability we need, we also have to commit ourselves to sensible regulatory reforms that are genuinely geared to bolstering the resilience of the international financial system.

II Regulatory reform

1 Some key elements of regulatory reform

Before enlarging on the regulatory lessons to be drawn from the crisis, let me start with an overview of some key elements of regulatory reform.

Firstly, what is meant exactly by “regulatory reform”? Has the current crisis ended the era of deregulation? Should authorities now rush towards re-regulation? Simply calling for *more* regulation misses the point somewhat. It is the quality not the quantity of regulation that counts. We have to aim for <u>*good* regulation</u>, thereby striking a balance between safeguarding financial stability and allowing for innovation. The regulatory framework needs to be repaired rather than rewritten or massively expanded. By the same token – notwithstanding a great deal of pressure to act – accuracy is more important than speed. Half-baked reforms might lack consistency and could prove to be costly owing to their unintended side effects. Given market participants' ingenuity, such side effects could include opportunities for regulatory arbitrage. Good regulation is key.

Secondly, in the preferred model of a market-based economy and financial system, market discipline still has a role to play. I would therefore like to caution against trying to fully substitute sovereign regulation for market discipline. Rather, regulation needs to be designed and used to create market discipline – for example, imposing a suitable degree of transparency. This approach would allow more flexible and less costly market-based solutions.

2 Lessons from the crisis suggesting specific regulatory changes

In order to achieve regulatory improvements that substantially strengthen financial stability, it is essential to undertake an in-depth analysis of the underlying causes of the crisis. In this context, the work of the Financial Stability Forum – recently re-established as the Financial Stability Board – deserves special attention. As early as April 2008, the FSF (commissioned by the G7) published its first report. The report carefully analysed the causes of the crisis and the work of the FSF has been incorporated in the action plan agreed at the G20 summits in Washington and London. The 67 recommendations of the FSF Report are still highly relevant today and have been – or are being – implemented.

Let me now pick out three areas where the lessons of the crisis suggest specific regulatory changes.

Firstly, the crisis has revealed shortcomings in prudential rules. Market participants have a natural tendency to try to find methods to evade regulatory rules. Financial institutions shifting credit risks to off-balance-sheet vehicles was a typical form of such regulatory arbitrage. In doing so, banks used a loophole in the old Basel I regime which did not capture these vehicles or the liquidity lines granted to them. This loophole has been closed by Basel II.

In light of the crisis refinements of Basel II are under review, as well. The Basel Committee on Banking Supervision has already proposed a number of such refinements and is working on further improvements. But it is important that regulators will act cautiously. While there is a broad consensus on raising the level and quality of capital required in the banking system, there is also broad consensus on not doing so while the crisis is in full swing. Until recovery is assured, the standard for the minimum level of capital should remain unchanged.

Secondly, the financial turmoil has revealed a number of shortcomings in the credit rating process. Rating agencies have underestimated the credit risks contained in structured products, thereby contributing to both the build-up and the unfolding of recent events. At the same time, credit ratings are referred to in various regulatory and supervisory frameworks. Against this backdrop, what now seems to be warranted is a system of registration and oversight for the agencies. This system should aim at safeguarding rating quality and proper management of the agencies' inherent conflicts of interest. The IOSCO Code of Conduct Fundamentals are an excellent point of reference in respect of good governance at rating agencies.

Regulation of rating agencies, however, must not be construed as an official seal of approval for their ratings. Ratings cannot and should never replace appropriate risk analysis and management on the part of investors. Investors need to make independent judgements of risks and perform their own due diligence. In order to enable this due diligence, rating agencies should provide full disclosure regarding the methodologies used as well as the assumptions underlying the ratings. Beyond establishing an oversight regime for credit rating agencies, authorities are reviewing the roles they have assigned to ratings in regulations and supervisory rules. The G20 have asked the Basel Committee to take forward its review of the role played by external ratings in prudential regulation.

Thirdly, I want to turn to the subject of transparency. Transparency is necessary for the identification and assessment of risks as well as their management. It is also essential for making market discipline work and is an important means of maintaining confidence among market participants under stress. Complex financial instruments used for credit risk transfer have significantly changed financial systems over recent years. However, the risks contained in these derivatives are often still unclear.

Private sector initiatives are key for ensuring transparency in this area, as well. Regarding credit default swaps (CDS) we are witnessing gradual improvements in market transparency. The establishment of central clearing facilities will further enhance transparency and reduce counterparty risks. Only if these efforts are not finalised or are not implemented properly, regulators will have to think about exacting the provision of relevant information and data.

3 Lessons from the crisis suggesting change in regulatory principles

Having discussed these specific regulatory lessons, we should take a somewhat broader approach and take a look at challenges regarding the principles that lie behind regulatory regimes. Issues to be highlighted here are procyclicality, a macro-prudential approach and cooperation.

Regulation can be procyclical, that is amplify the natural upswings and downswings of the financial system and subsequently the economy. If this leads to boom-bust cycles, the functional viability of the financial system is jeopardised. An example of cyclical elements within our current regulatory framework may be found in the risk-sensitive minimum capital requirements under Basel II. These are based on probabilities of default that tend to rise in downturns. In addition, fair value accounting, which leads to valuations fluctuating along with market prices, has also come under scrutiny as regards procyclicality. During the upswing, fair value accounting contributed to the build-up of the massive leverage in the system. After the cycle had turned, fair value accounting accelerated the deleveraging, thereby aggravating the financial crisis.

The traditional, primarily microprudential approach (that is, looking separately at individual institutions) has proven to be too narrow. We have to complement microprudential supervision with a macroprudential perspective. This must include taking due account of the macroeconomic background.

To achieve all this, cooperation is key. Any system-oriented approach depends crucially on effective collaboration between regulators, supervisors and central banks. This cross-border communication and cooperation needs to be carried out in a more systematic way. As an example, I would like to mention the recent call for a European Systemic Risk Council (ESRC). An ESRC would be responsible for pooling and analysing all information relevant to financial stability, pertaining to macroeconomic conditions and to macroprudential developments.

We have recently witnessed some international convergence in attitudes. There is now a common understanding among the G20 members that all systemically important financial institutions, markets, and instruments should be subject to appropriate regulation and oversight. Filling out the details of this general agreement will be difficult nevertheless; the definition of systemic relevance is only a start in this respect. A measured approach is needed to redefining the appropriate perimeter and intensity of regulation. Authorities must be able to identify and take account of risks across the whole financial system; however they need not regulate everything in great detail.

As an example, I want to point out hedge funds. A typical feature of hedge funds is their use of high financial leverage. This means that the actual volumes of their transactions far exceed reported assets under management. Given their major importance and large transaction volumes, they can both cause and intensify market disruptions. Moreover, they are borrowers from and counterparties to systemically important financial institutions.

Hedge funds are, however, not at the centre of the ongoing crisis. But as a part of the so-called shadow banking system, they played a role in the strong pre-crisis expansion of credit. And there are good reasons to see them as a major force in the process of – at times – very rapid deleveraging. In the future, the hedge funds will become subject to reporting requirements.

They will have to provide, on an ongoing basis, information which should at least encompass assets under management, leverage and broadly grouped investment exposures – while detailed reporting of positions need not be required.

III Regulatory landscape following the Washington and London summits

Before concluding, I would like to direct your attention to some material changes in the regulatory landscape that have been brought about by the crisis.

The first trend is an intensification of international cooperation. Overall, cross-boarder communication and cooperation have worked fairly well when financial institutions have run into difficulties. There is no doubt that international cooperation will be stepped up further. For instance, supervisory colleges for significant cross-border firms have already been put in place and others will be established by June 2009. This will further enhance cross-border exchange of information among supervisors. There is also a window of opportunity to include offshore financial centres.

Secondly, I want to draw your attention to recent changes in the institutional set-up. In this respect, an important change is that systemically relevant emerging market economies, not the least South Africa, now fully participate in all aspects regarding international economic and financial cooperation, and rightly so. This can be seen clearly from the fact that the most relevant arena for financial issues is now the G20 rather than the previously dominant G7. The increased importance of emerging market economies is also reflected by the expansion in membership of the former Financial Stability Forum and the Basel Committee on Banking Supervision.

Another important fact has been the decision of the G20 to enhance the role of the FSF. Its mandate to promote financial stability has been strengthened and it has been re-established with a stronger institutional basis as the Financial Stability Board (FSB). This means that the FSB is in a position to go on playing its leading role in global financial regulation.

IV Concluding remarks

At the risk of oversimplification, I would like to conclude with five statements:

1. Regulatory reform is good only if it produces *good* regulation.
2. Good regulation pays attention to the macro picture and to what it does to the *system as a whole*.
3. International cooperation is indispensable in devising good regulation for the global financial system.
4. Good regulation needs a companion, and that companion is good supervision that enforces regulation.
5. Supervision needs to act on early warnings of risk.