

Future of the Financial Regulatory Framework – Role of Market Regulations and Regulators

Speaking note of Philipp Hildebrand, Vice-Chairman of the Governing Board, Swiss National Bank, for the IOSCO Technical Committee Conference, 8 October 2009

Introduction

Since the peak of the financial crisis, the functioning of the financial system has improved very significantly. The global economy has begun to recover, though pertinent questions remain regarding the recovery's sustainability. Progress has been possible thanks to unprecedented public policy measures in support of the global financial system on behalf of our economies.

Given the immense cost - both tangible and intangible - of these support measures, this is not the time for complacency on the part of the public sector. We must complete our efforts to ensure fundamental reform of the global financial system.

This is also decisively not the time for banks to push back against these regulatory reforms. The welcome return to profitability by many banks must instead be an occasion for them to pursue vigorously the strengthening of their capital base.

Intensive efforts are underway to increase the resilience of the financial system. Good progress is being made on many measures, including in the way banks are reorienting their business models and operating procedures. But many of the final implementation challenges lie ahead. Fully in line with proposals by the Financial Stability Board (FSB) and the decisions by the G20 leaders, I am convinced we need to pursue a dual-track approach to reforming the global financial system, combining preventive measures with measures facilitating the orderly resolution of large international banks in the event of a future crisis.

Preventive measures

Preventive measures should focus on strengthening the shock absorbers of the financial system. In the context of the most significant banks this essentially means that they have to hold substantially more capital and more liquidity.

Strengthened shock absorbers in the form of higher capital and liquidity buffers have several obvious beneficial effects.

First, bigger buffers enable banks to absorb larger negative shocks without triggering an idiosyncratic, let alone a systemic crisis.

Second, they ensure that banks themselves bear a larger share of their downside risks. Not only does this reduce the potential burden for taxpayers, but it also creates stronger incentives for the banks themselves to operate prudently.

Third, if shareholders know that they have to absorb potential future losses rather than passing them on to taxpayers, they will likely become less willing to let management engage in excessively risky activities. Ultimately, this incentive effect can help make future crises less likely.

Strengthening capital requirements

The crisis revealed a number of fundamental weaknesses of existing capital requirements.

While model-driven risk-weighted capital requirements are sensible and should be maintained, they are clearly not infallible.

Despite risk-weighted capital ratios that in most cases exceeded the regulatory minima, leverage was a key source of vulnerability going into the crisis. Excessive leverage not only intensified the impact of mistakes on the financial situation of individual banks. It also amplified the crisis as ongoing de-leveraging in the industry inevitably put downward pressure on financial markets and on the real economy.

It is now also clear that banks were undercapitalized at the start of the crisis. Mounting losses quickly depleted their capital base, and, with a few notable exceptions, the banks found themselves in desperate need of massive support measures by the public sector.

To address these weaknesses, a considerable amount of work has been done and is still underway in the FSB and in a number of working groups of the Basel Committee on Banking Supervision. In line with, and in full support of these efforts, I am convinced that a more robust capital framework needs to be built around the following features:

First, the amount and the quality of capital have to be increased very substantially. In the medium term, this will be feasible without causing drastic adjustments at banks that might be harmful to the real economy. The key to this will be more discipline in retaining earnings. Reviewing the banks that received public support, many of them paid out more in dividends and share buybacks during the years preceding the crisis than they subsequently faced in losses.

Second, as a supplement to the risk-based capital requirements, a simple and commonly defined leverage ratio restriction needs to be introduced of the sort already applied in Switzerland, Canada or the United States. A leverage ratio prevents the buildup of excessive leverage and serves as a backstop to the complex, but fallible risk-based capital requirements.

Third, to address procyclicality, banks will have to build up capital buffers above the minimum requirements in good times. In difficult times, banks will be allowed to fall significantly below the target levels defined for good times. Allowing banks to draw down capital without violating any minimum requirements helps to mitigate the harmful effects of de-leveraging.

More robust liquidity requirements

The crisis has also provided a number of important lessons regarding liquidity. In short, banks' liquidity holdings were insufficient. This holds true for the quantity but also for the quality of liquidity.

One of the explanations for these insufficient holdings of liquidity was that the stress scenarios considered by banks were far too optimistic. While secured funding remained the most stable source of refinancing, it was much less stable than what banks and regulators had assumed.

Moreover, it quickly became apparent that liquidity problems at single banks imposed considerable stress on the entire international system.

As in the area of capital, the FSB and the Basel Committee are working at full throttle towards an internationally coordinated liquidity standard for banks. In my view, this internationally harmonized standard needs to have the following basic features to be effective:

The standard should reflect a very adverse scenario. The standard should require banks to hold a buffer consisting of assets whose liquidity and value is robust to massive disruptions in the financial markets.

As a consequence of stronger capital and liquidity requirements, banks of the future may seem more boring, with lower return on equity, but less risky and, frankly, probably socially more useful.

With such changes must come a change in banks' compensation policies and practices. Compensation cannot be a one-way street and must become risk aligned and long-term oriented.

Facilitating the orderly resolution of banking problems

Prevention is key but it will not be foolproof.

Even with these better shock absorbers in place in due time, large and systemically important banks will again experience severe financial stress at some point in the future. Here we must accept that we still have not dealt with the fundamental reason why systemically important banks cannot be allowed to fail. The truth is that, if tomorrow

morning a systemic institution were to be on the brink of failure, we would again face the terrible choice of coming to its rescue or risking the stability of the financial system.

Moreover, as long as banks can expect public support, market discipline will not curb their risk appetite and they will constantly seek to arbitrage the prudential requirements.

Moral hazard is exacerbated by the fact that there is no longer any ambiguity about the willingness of the public sector to bail-out large banks. In other words, we must recognize that the wide-ranging public support measures have exacerbated the moral hazard problem associated with large and complex global financial institutions.

Frankly speaking, we have no choice but to address the specific challenges of banks that are «too big or too interconnected» to fail. If we are committed to a market-based system, the financial system of the future must expose financial institutions of all sizes and structures to the test of the market place. In the event that some of them face the threat of failure in a future crisis, we need a system that allows for the orderly resolution of large and complex financial institutions. This system needs to ensure that a failing bank can continue to fulfill the functions that are critical for the functioning of the economy.

There are at least three possible routes to achieve this goal. We need to examine all the available options with an open mind: the optimal policy may well combine elements of all three, as opposed to one silver bullet.

First, we should strive for an internationally agreed and orderly process to allow the wind down of large, systemically important financial institutions in the event of extreme crisis.

- Obviously, there are many technical and legal problems that have impeded any meaningful progress in reaching international coordination in this matter. But I would argue that the real problem has not simply been a lack of technical answers to admittedly very difficult problems. What we have needed was a bold and international political commitment to put in place a framework for the orderly resolution of cross border financial institutions. Provided we have such an unequivocal commitment, solutions will eventually emerge.

- Of course, we must accept the reality that different national resolution regimes will continue to coexist. To make it very clear: I am not proposing to create a global resolution regime to replace national regimes. This does not mean, however, that there is no possibility of improving the framework for cooperation across countries, for example combined with mutual recognition of national resolution regimes.

Second, we should require that firms more clearly delineate different functions within their internal structures and simplify those structures. This will help facilitate an orderly wind down in the event of a severe crisis.

And third, as an ultimate resort, we cannot ignore the need to consider measures that address the size of the banks indirectly or directly.

All this will naturally require a close dialogue and meaningful cooperation between the public authorities and the banks.

Ultimately, we need a system that prevents destabilizing effects of a failure on the rest of the financial sector. A key element which cannot be emphasized enough is the ongoing effort to centralize the clearing and settlement processes and thus reduce counter-party risk in the derivate market.

Conclusion

The worst of the crisis is behind us, and there are intensive efforts under way to increase the resilience of the financial system. Banks are again generating profits and, in some cases, very substantial profits, not least because of the costly public support measures, many of which remain in place.

As the situation improves, complacency can easily become the rule of the game. We forget the severity of the crisis and fall prey to renewed lobbying of a powerful and recovering industry.

We on the public side must not let this happen. Equally, the most prominent banks should invest themselves not in resisting change but in genuinely supporting the efforts of

bringing it about in the interest of a more long-term oriented and less volatile economic growth model.

Strong and bold entrepreneurial and political leadership is now required to see the necessary changes for the financial system through, as demonstrated by the G20 leaders in Pittsburgh two weeks ago. Clearly, there are many areas in financial regulation that can and should be improved. Given what is at stake, there is a need to prioritize. I have briefly laid out to you today where I see those priorities.