

Institute for Monetary and Financial Stability

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„ Banking Regulation after the Financial Crisis“

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Banking Regulation after the Crisis

□ Agenda

- I. All Lessons learnt?
- II. The Role of Capital Requirements
- III. Systemically Important Banks
- IV. Future Financial Architecture
- V. Resumé: Risks Ahead

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□ I. All Lessons Learnt?

- Very specific origins of financial crisis
 - US-subprime mortgage market
 - Weak conditions of lending on this market
 - Worldwide distribution of risks via securitisation
- Very broad causes of the crisis
 - Open capital markets
 - Role of big central banks
 - Global trade imbalances
 - Role of IFRS and remuneration schemes
 - Organisation and focus of supervision
- Main policy perspective today
 - Avoid future breakdown of global financial system
 - Reduce direct and indirect costs of future banking failures

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□ II. The Role of Capital Requirements

- Limited functionality of capital requirements
 - Quantitative restriction of banking business
 - Loss buffer?
 - Quantitative basis for mutual trust on markets
- High hurdles for effective implementation
 - Extreme complexity and technicality of rules
 - Diverging perspectives of regulators and banks
 - Basel II: cover more risks (default, market, operational) with less capital under complex IRBA models
 - Industry perspective: Profitability as main incentive for reducing costs of regulatory capital under any model
 - Solution of conflict between cost reduction and risk coverage depends under Basel II on quality of risk models/risk management
 - Conflict increases when capital requirements are raised

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□ II. The Role of Capital Requirements

- High esteem for internal risk management instruments under Basel II
 - Necessary and also effective, but
 - Only procedural tool
 - Regulatory guidance only principles-oriented
 - Mainly retrospective approach (but for stress-test?)
 - Strong dependencies on relevance and quality of mathematical modelling
 - Impact of models on actual decision-making?
 - Hazard of all models: “We have everything under control”

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□ III. Systemically Important Banks

- Systemically important banks vs. systemic risks?
- “Systemic factors” in the financial markets
 - Payment systems; securities clearing and settlement systems
 - Very large and/or complex and/or interconnected banks
 - Regulation and rating (!) that favour parallel (nearly identical) market strategies and lead to risk concentrations
 - Regulation that induces excessive risk taking (in particular deviation/avoidance strategies)
- Systemically important functions
 - Payment functions
 - Credit functions
 - Risk transfer functions

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□ III. Systemically Important Banks

■ Potential solutions

- Banking business as going concern
 - New “Glass-Steagall” (qualitative separation of business)?
 - Breaking-up oversized banks (quantitative division of business)?
 - “Special-regime” for trading book activities within a bank?
- Crisis resolution schemes
 - Recapitalisation (who will pay when and how much?)
 - Reorganisation (living will or how to cut a bank into nice slices that someone will buy?)
 - In particular: competences and burden-sharing in cross-border resolutions
 - In particular: termination and EoD clauses under ISDA Master Agreement 2002
- Harmonisation of “tools”
 - EU law so far does not provide any precise harmonisation of material powers enjoyed by authorities, cf. Art. 54, 136 CRD
 - Co-ordinated measures only effective on the basis of harmonised powers including conditions and legal consequences

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□ IV. Future Financial Architecture

■ Germany: incorporating banking supervision into the Bundesbank

- Combining macro- and microprudential supervision under one roof
- But: Independence of central banks in supervisory matters under Art. 130 TFEU?
 - No, as long as task was not conferred by primary law!
 - Sole legal basis for task: Art. 127 (5) TFEU: “contribution to the smooth conduct of policies pursued by the competent authorities”

■ EU: Establishment of European Banking Authority

- Background: weak legal structures for cooperation between national supervisors under Directive 2006/48
- Arguable legal basis (Art. 114 TFEU) for Commission proposal
- No harmonisation of material powers of national supervisors
- Unclear, potentially broad powers of EU Banking Authority towards
 - National supervisory authorities and credit institutions
 - Would violate rule of law (legal certainty) under Art. 2 TEU
 - Would violate principles of direct applicability of directives

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□ V. Resumé: Risks Ahead

■ Over-sophistication

- of financial instruments and of regulation - a cat-and-mouse-game?

■ The international "level playing field"

- Benefits of internationally operating banks
- Cost of capital and supervision vs. costs of bank failures
- Influence of regulatory answers in the US and China on EU approach
- Re-regionalisation of markets?

■ Viability of "lender of last resort"-policies

- Central banks and monetary stability
- Governments and sustainability of public debt
 - Absolute amount of public debt/annual refunding (gross deficit)
 - Direct and indirect costs of public debt