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The new architecture of financial regulation:
Will it prevent another crisis?

by

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[Dean Davies, Lord Turner] Ladies and Gentleman,

In his recently published tome "Why the West Rules -for Now", Stanford historian Ian Morris argues that human destiny is shaped by the efforts of people to cope with whatever is thrown at them. He observes, and I quote: "History teaches us that when the pressure is on, change takes off," end of quote. Indeed, it is the natural instinct of human beings to ask after every catastrophe: What can we do to avoid a repetition of such an experience? The financial crisis is no exception to the rule. It has triggered a strong resolve on the part of market participants, authorities and rule-makers to prevent a recurrence of the events that brought our financial system, indeed our economies close to the point of collapse two years ago. As I will develop in greater detail in this lecture, I think it is fair to say that the collective efforts of all of us who have been working towards that objective are beginning to bear fruit.

Before I start off, let me just mention *en passant* that the real subject of Professor Morris's book, namely an analysis of geopolitical power shifts across the century, is an aspect that is also pertinent in the debate on the consequences of the financial crisis. Just a few days ago, on the occasion of the IMF/World Bank Group Annual Meetings in Washington D.C., we were once again able to witness the new balance of power between the West and the rising powers in Asia and Latin America. The debates on currency regimes, macroeconomic policies and influence in international organizations were a reminder that the financial crisis was not just an economic event. Rather, it will prove to be a watershed event for geopolitics, too. We would be well advised to keep this in mind when we discuss regulatory changes to achieve greater financial stability and not lose sight of the fact that regulation can create and destroy markets and companies - and especially so in the financial industry where factors of production are so mobile.

Most rule-makers here in Europe are well aware of this. Indeed, this awareness partly explains why it is often so difficult to agree on regulation that strikes the right balance between competing objectives. These are legitimate discussions, which inevitably take time - and if that is the price for a sound evaluation of all potential consequences, it is a price well worth paying.

1) Banks' own efforts

After this brief digression into the field of geopolitics, I would like to comment briefly on the reforms that banks themselves have pursued before I delve into a discussion of the changes in the regulatory architecture. Like many others in the financial industry repeatedly stated in the wake of the crisis, I am also convinced that the first and most important line of defence for the financial system is the resilience of individual market participants.

Based on this conviction, banks undertook massive efforts to rectify the deficiencies in their systems and risk management that were revealed by and during the crisis. While many of these changes took place outside the view of public scrutiny and therefore are easily overlooked, one also has to admit that these efforts have not yet been fully completed. Yet neither of these observations makes such efforts any less important, for example, when it comes to bolstering the status of risk management and risk managers within banks. This also applies to changes made to risk models aimed at better capturing extreme events, different scenarios and correlations between the different risks in a diversified portfolio. In this context one could, indeed one must also mention the changes made to remuneration schemes, which have been adjusted to better align remuneration with sustainable profitability. Last, but not least, I would like to draw your attention to the banks' efforts to boost their capital base - quite independently from and well in advance of changes to the official capital requirements regime. Since the end of 2008, the top-20 banks in Europe alone have increased their capital base by 320 billion euros. For these banks as a group, the Tier-1 ratio increased by 210 basis points to 11%.

These actions show that banks are drawing the right lessons from the crisis. At the same time, it is clear that banks can only achieve so much. Regulatory change will need to complement their efforts.

2) Progress in and key principles for reforming regulation

After two years of discussion the new regulatory framework is now taking shape. Despite a wide-spread feeling that little has happened, the past thirty months or so have been used productively. Let me elaborate:

- In less than two years, members of the Basel Committee have agreed on a fundamental reshaping of the capital requirements regime. Let us not forget that it took no less than five years from 1999 to 2004 - to negotiate the Basel II accord, which is similar to Basel III in terms of complexity and comprehensiveness.

- In the two largest financial markets of the world - the U.S. and the EU - legislation on the key reform elements has either been presented or already passed. Although many of the implementation rules will still have to be set out in detail, the encompassing nature of legislation such as the Dodd-Frank Act leaves no doubt that financial markets will be fundamentally reshaped.

- The Basel Committee and the Financial Stability Board have expanded to include all G20 members. This is enhancing the legitimacy of the measures taken by these regulatory bodies and also making it more likely - at least in principle - that the new rules will be adhered to all around the world. In light of the increasing role of emerging market economies in the global financial system this is very important for securing a level playing field.

- In terms of content, great efforts have been made to align regulatory action across borders. No doubt, this has slowed down the pace of regulatory reform, but to the degree it enhanced the effectiveness of regulatory reforms this time is well spent.

- In fact, recent examples of failure to achieve international coordination have made it abundantly clear that isolated national action is not conducive to the common goal of enhancing the stability of the financial system, as it paves the way for regulatory arbitrage and distortions. Unilateral actions will undermine much of the benefits of the multilateral regulatory reforms that have been agreed so far.

There is a general consensus on the overarching objective of all reforms: To enhance the resilience of the global financial system while at the same time not jeopardizing the financial system's flexibility and ability to fully support innovation and growth of the world economy. Recent developments have raised serious concerns whether the regulators will strike the right balance between stability and flexibility.

3) Capital and liquidity requirements

Without a doubt, the revised capital and liquidity requirements are by far the most important building block for a more stable financial system. A lack of high quality capital in the financial system has rightly been identified as one of the causes for and a catalyst of the financial crisis. Therefore, to raise the quality and quantity of capital in the system is the right objective. Similarly, the crisis has highlighted the crucial importance of liquidity, which was neglected by both supervisors and banks in the long era of abundant liquidity prior to the crisis. Basel III will for the first time establish liquidity standards at the global level.

More contentious is the inclusion of a leverage ratio in the new capital regime. Of course, it is true that the leverage ratio does not fit in well with the risk-based capital regime established by Basel II. It is also true that it will be difficult to establish a leverage ratio that does not gravely distort competition as long as accounting regimes vary so fundamentally, especially with regard to the accounting rules for derivatives. Nonetheless, I can understand the rationale behind wanting to control the leverage of financial institutions to a greater extent than in the past.

While I continue to be sceptical about the usefulness of the leverage ratio as a Pillar 1 instrument, I can see merit in monitoring leverage in the context of Pillar 2. In such case, a leverage ratio can be a practical tool that can help both management and supervisors pay due attention to the development of business volumes and risk. Many of the past developments that - with the benefit of hindsight - should have been avoided, like the enormous expansion of trading books, may not have occurred if leverage had been of more concern to management and supervisors.

Overall, it seems to me that the Basel III proposals presented on September 12th, strike the right balance between establishing greater stability through tougher rules and at the same time limiting negative repercussions on the financial system's capacity to fund innovation and growth. Extended implementation periods and a phasing-in of the new rules will greatly help to contain the macroeconomic impact of the new rules.

While the broad conceptual design of the new framework for capital and liquidity therefore is to be lauded, a number of concerns remain:

- First, we must not underestimate the cumulative impact of all regulatory changes, which of course go far beyond capital requirements. The latter are just one instrument that will weigh on banks' capital and profitability, alongside levies, surcharges, reformed deposit insurance schemes and higher collateral requirements in the derivatives markets, to name but a few. And when I say "cumulative impact," I mean the cumulative impact not just on banks' profitability but also on the overall economy.

  Sound profitability - combined with a sound policy on dividends and buy-backs - is the best way to guarantee stability. It allows banks to build a solid capital base and to cover potential losses from recurrent earnings. It would be a grave mistake to assume that banks will be able to maintain their current business volumes - let alone expand these substantially - if profitability drops markedly due to higher regulatory requirements.

  Banks must remain an attractive investment to investors, as otherwise they will struggle to raise fresh money. Demands for Tier-1 capital ratios of 20% as proposed by some academics could depress RoE to levels that make investment into the banking sector unattractive relative to other business sectors.

  According to some industry observers' estimates the industry's overall profitability levels could drop by roughly a third due to the new regulations. This would clearly put banks with a low level of profitability deeply into the red and their existence in doubt - a worrisome scenario without an exit strategy in place that is containing ripple effects for the banking sector and the economy as a whole.

  Of course, the macroeconomic impact of the capital requirement reforms will be determined by whether or not banks are able to close the capital gap organically and/or through raising fresh capital. As you know, a lot has been written about this in recent weeks and simulations have produced results that appeared to vary enormously, at first glance. It is important to note here that the studies have revealed how sensitive these simulations are to assumptions, especially the assumptions on the elasticity of the supply curve for bank capital and the feasibility and probability of certain policy reactions. Even small differences in assumptions can produce large variations in the results .

- The second concern I have: While regulators have commendably set long transition periods for attaining the new capital ratios, markets, in other words, investors, counterparties and rating agencies may not be quite so patient. In the recent roadshows for Deutsche Bank's capital hike I learned that investors will not wait until 2019, the year when Basel III requirements fully apply, but want to see banks meet the full requirements by 2013 already, the start of Basel III.

  I also learned that investors view the capital conservation buffer, or CCB, not as a buffer, but simply as an additional cushion of capital that must not be expended in times of crisis. The name "capital conservation buffer" therefore is a glaring misnomer, as it will not serve as a buffer. Instead, banks will have to make sure that they never come close to the limit defined by core tier-1 requirements plus CCB. In other words, the real buffer is the 1 or 1 .5% of additional core tier-1 capital that banks will -*whether they want it or not* -have to hold in excess of common equity plus CCB requirements. At our roadshows it also became clear that investors will require all leading global banks to have similar capital ratios - irrespective of what national supervisors may stipulate in the context of their national discretionary scope and irrespective of the bank's individual business model. This clearly is not what rule makers had in mind and what would be desirable to support the still fragile recovery of the world economy.

- My third concern is that some of the measures**,** such as counter-cyclical buffers and surcharges for systemically important banks, have not yet been fully fleshed ou**t** -creating uncertainty as to their impact on banks and the economy. In fact, in both of these cases it appears that a lot of conceptual work still needs to be done before they should be put into place. With regard to counter-cyclical buffers, defining excess credit growth is by no means a trivial task. Buffering, which is outside the control of the banks themselves, will also make forward looking capital management and communications with investors more difficult. Moreover, it is worrisome that setting the counter-cyclical buffers which can amount to up to 2.5% of risk weighted assets, is to be left to the discretion of national authorities, opening the door to significant distortions in competitiveness. As to the surcharges for systemically important banks, it is well-known that efforts have been made for some time to define systemically important institutions.

But so far these efforts have borne little fruit. One insight gained from these deliberations is that size alone is not a good proxy for systemic relevance. Interconnectedness is surely a better indicator - but I think it is fair to say that we have not yet established operational criteria to measure interconnectedness. In any case, we need to keep in mind one of the lessons of the crisis: Systemic relevance of a financial institution is a fluid concept. Before the crisis, who would have thought that a widely unknown bank named IKB in Dusseldorf, Germany was systemically relevant or Northern Rock in the U.K. for that matter? But if systemic importance cannot be defined properly, then the rationale for imposing capital surcharges on banks deemed systemically important becomes spurious and is likely to generate questionable results.

In light of all these issues and there are some more which I cannot deal with here because of time constraints, it remains important that we proceed carefully in implementing the new rules and that in particular we take into account the cumulative impact from financial sector regulatory reforms on economic growth. Please do not misunderstand me: The banks have supported financial regulatory reforms from the outset, and we continue to believe that such reforms are essential for the safety and soundness of the financial system. At the same time, there can be no doubt that Basel III alone will have short to medium-term economic costs. These costs might explode with all the add-ons that are currently discussed and paying sufficient attention to this is all the more important considering the many uncertainties related to the world economic outlook.

There is another important aspect concerning the implementation of the new capital and liquidity rules, namely the international alignment of their implementation.

Massive shifts in competitiveness would result if banks around the world were not subject to the same standards.

Therefore the G20 leaders should, at their summit in Seoul in November, endorse the capital and liquidity regime of Basel III, as proposed, and firmly commit to its timely and full implementation within their respective jurisdictions. Similar transition paths and a common endpoint must be defined for all major financial markets. Otherwise, acceptance of the new regulatory regime will suffer and serious competitive distortions will be inevitable.

4) Other necessary regulatory elements

Capital and liquidity requirements are rightly seen as the cornerstone of the new regulatory framework. They are indeed necessary elements for greater financial stability, but they are not sufficient. We would be ill-advised to assume that higher capital ratios are a panacea to all weaknesses of the financial system. Additional measures are needed to effectively address the deficiencies of the system.

a) Effective supervision

The first among these is to make supervision more effective. Designing new rules is one thing - but even the best rules are useless if adherence to them is not properly and effectively supervised and enforced. Against this background it is difficult to overstate the importance of robust and efficient supervision. The supervision of complex firms needs to be more in-depth than in the past and better attuned to their risk profiles and business models. Supervisors in many countries need more resources, better training and the wherewithal to be truly effective interlocutors of banks. They should be in a position to challenge banks' management on the basis of sophisticated risk and market understanding. Banking supervision of crossborder institutions needs to be internationally consistent and coordinated through well functioning "Supervisory Colleges" .

Similarly, market supervision will become even more important. One only needs to look at the large number of tasks that have been assigned to the SEC and the Commodity Futures Trading Commission (CFTC) in the Dodd-Frank Act and to the European Securities Market Authority (ESMA) and national market supervisors on this side of the Atlantic to get a feeling for the monumental tasks that lie ahead of these authorities. Just to illustrate by way of example: As we build more complex infrastructures such as central counterparties (CCPs), more responsibility will rest on the shoulders of those who supervise these entities.

The financial industry looks forward to working with prudential regulators and market supervisors on these challenges. Let me add that close cooperation will be particularly important in the EU, where we are in the process of establishing a new supervisory architecture. The recently found compromises must now be transformed into workable and effective practical arrangements. Jacques de Larosiere has just set out the challenges that lie ahead of us in this regard - and I certainly would not suggest that I can add substantially to his comprehensive analysis.

Let me just say that I share the view expressed by many, not least in the European Parliament, that the compromises found constitute at best a minimum of what is needed to establish an effective supervisory structure in the EU to bolster the stability and competitiveness of our home market. It will be all the more important therefore that the new supervisory bodies make full use of their new powers; that they are put in a position to attract the best and brightest staff; and that national supervisors fully support their work.

b) Transparency

Another important measure of the new regulatory regime will be to enhance transparency. This was high on people's minds - and rightly so – in the immediate aftermath of the crisis, as a lack of transparency was widely identified both as a cause of and a catalyst during the crisis. Of course, progress has been made in addressing this deficiency. Let me cite just three initiatives to illustrate this progress.

- First, in securitization markets, efforts are underway to give investors better disclosure on the underlyings so that they can perform their own due diligence rather than simply rely on the judgement of rating agencies. Moreover, in Germany, a premium segment has been established under the aegis of the True Sale International initiative, which has been very successful in restoring investor confidence. A comparable initiative - the Prime Collateralised

Securities, or PCS, initiative - is being pursued at the European level, not least with the support of the European Financial Services Round Table.

- Second, a key element of regulatory reforms for the derivatives markets is the establishment of trade repositories. These will significantly enhance supervisors' knowledge about exposures in these markets and about the distribution of risks in the financial system.

- Third, the successful stress tests conducted on a pan-European basis in July constitute a milestone in the quest for greater transparency. One can, of course, argue about the appropriateness of the scenarios simulated in the stress tests. There is no denying, however, that the stress tests have given investors and counterparties an unprecedented level of detail on banks' sovereign exposures, which in turn has certainly contributed to a normalization of the financing situation of European banks.

c) Macro-prudential supervision

A third element in the new regulatory regime is macroprudential supervision. This fills an important gap in the supervisory architecture. A regular analysis of the resilience of the financial system as a whole, of interconnectedness and issues of procyclicality is a longoverdue and valuable component of financial supervision. While the institutional framework for the new systemic risk supervisors is now in place, the operational framework is not. The new bodies will quickly need to achieve credibility in the markets by virtue of the quality of their analyses and recommendations. Here, it will be important not to shy away from politically sensitive issues. It will also be indispensible for the work of the various macro-prudential supervisors to be coordinated internationally, to prevent differences in their statements from creating confusion in markets.

d) Extend oversight to the shadow banking system

Fourthly, one of the important tasks of the new systemic risk supervisors will be to closely watch the shadow banking system. Indeed, in the U.S., the Financial Stability Oversight Council (FSOC) has been tasked with identifying all financial companies that are relevant for financial stability, whether regulated or not, and will have powers to impose obligations on them. The European Systemic Risk Board (ESRB) unfortunately has no such powers.

It has been widely documented that the rapid expansion of the shadow banking system was the underlying cause for the huge increase in the financial system's leverage before the outbreak of the crisis. The task of monitoring and, if need be, addressing similar developments in the future has not become any less important. In fact the shadow banking system may very well become attractive again, as the regulated part of the financial system is subject to ever stricter requirements.

These four measures are primarily aimed at crisis prevention; I would now like to move on to discuss two further elements of the new regulatory architecture that are principally designed to reduce potential spillovers from a failed institution.

e) Financial market infrastructure

The first element here will be to strengthen the financial market infrastructure. Amid all the fanfare on the details of derivatives market regulation, there is a risk that the principal objective of strengthening the market infrastructure may become lost. And this objective is to enable the financial system to better withstand the failure of a market participant by replacing a web of bilateral relationships with central counterparties and by requiring adequate collateral for each contract. This is not to suggest that the various issues currently under debate in the context of designing rules, for instance, the forthcoming Market Infrastructure Regulation here in Europe, are not important. On the contrary: Specifying which trades and market participants will be exempted is clearly very important; determining the requirements CCPs will need to meet for authorization is very important; and who and what criteria will determine eligibility for CCP clearing are very important issues as well. The key point here, however, is that these and other relevant questions must be viewed and answered through the lens of the fundamental objective. In other words: Do the envisaged solutions help to markedly increase the resilience of the financial system?

I believe the recent proposals by the European Commission outline an adequate framework for this. As we move forward in setting out the details of these proposals, it will be imperative not to lose sight of the underlying motives.

If we succeed in this, I am confident that this important building block can be put firmly in its place.

f) Effective structures for an orderly winding down

And this brings me to the final element that I want to discuss today: restructuring and resolution regimes. The work here is arguably the last major building site for the new financial architecture. Admittedly, some progress has been made in this area: The Dodd-Frank Act awards broader resolution powers to the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC), also to include non-bank financial firms. Similarly, legislation has just been presented to the German parliament which would establish a special recovery and resolution regime for banks. Here in the UK, the Special Resolution Regime already took effect in February 2009. And the Basel Committee's Crossborder Bank Resolution Group has issued a thoughtful report in March 2010, which discusses the full range of cross-border aspects of resolution regimes. Again, let me remind you why work on restructuring and resolution regimes is so crucial: The answer of course is that resolution regimes are our best answer to the "too interconnected to fail" problem. In a market economy it must be possible for all firms to fail - irrespective of their size. This must also hold true for financial institutions, including banks. I fully share the objective voiced by many politicians and supervisors that we must do everything we can to ensure that there are alternatives to using taxpayers' money to deal with the failure of a large, interconnected financial institution. Recovery and resolution as well as insolvency regimes are the right solutions to achieve that objective. They target the problem at its root, i.e. how to organize an orderly process for the recovery and resolution of a financial institution whose failure would otherwise negatively affect other healthy parts of the financial system. By defining processes for dealing with the underlying problem, if it does arise, this approach has the least side-effects on the efficiency of financial markets in normal times and sets it apart from other proposals to deal with the "too interconnected to fail" problem, like cutting down the size of banks.

Although due to its simplicity this proposal enjoys a lot of support but it ignores at least two important things:

First of all, if a great number of smaller banks were to replace the business volume of one large bank, this would not necessarily make the financial system more stable because the number of interconnections between these institutions could most likely be even larger and, in any case, more difficult to monitor than those of one large bank. Moreover, if a large number of small banks follow essentially the same business model, they will be similarly susceptible to a common shock. The U.S. savings and loan crisis in the 1980s was a striking example of this. Collectively, smaller banks are no more stable than one large institution.

Secondly, it is essential to recognize that constraining large firms would undermine their capability to fully perform their functions as catalysts and intermediaries of global investment and trade expansion. Limiting the size of banks would therefore result in a loss of overall prosperity.

This shows how important it is that we make progress in instituting resolution processes. We must keep in mind that a financial institution in distress passes through several phases. Although these phases tend to meld into each other during a crisis, it is nonetheless useful to differentiate the different phases as distinct instruments are required to deal with each of them. Let me illustrate:

- First, we need to realize that problems can accumulate well before market stress builds up for an institution. In other words, although an institution may have no problem in obtaining funding in the markets, weaknesses may build up nonetheless. Often, this will be in times of very benign market conditions with low default rates, low interest rates and strong growth - in other words, conditions such as we saw in the years before the last crisis broke out. In such an environment, inherent weaknesses often go unnoticed by counterparties, but also by management itself. One such weakness may be the lack of a solid business model that would generate sustainable earnings even under less benign circumstances. As mentioned earlier, in such a scenario, it can be useful to have a supervisory agency that acts as a strong sparring partner for a bank's management by challenging unsustainable business models. If need be, supervisors must exercise early intervention rights to bring the bank back onto a sustainable business course.

- Second, for the recovery phase, banks should have instruments at their disposal that allow them to put an ailing institution on a path back to health. Contingent capital arrangements are one such instrument. I believe that contingent capital should be part of any bank's sound capital management. Having said this, it will be interesting to see just how great investor appetite is for such capital instruments. There is some concern, which I share, that the investor base may be limited and that such instruments will be very expensive.

  Another important precondition for successful recovery plans - and, even more so, for restructuring, should recovery fail - are organizational structures that make it possible to split off systematically irrelevant parts of a bank from the systemically relevant operational parts. It should be noted that this does not necessarily mean creating subsidiaries. Even in a subsidiary structure, interconnections between corporate units can be difficult to disentangle. Instead, it is essential to keep corporate structures as lean and transparent as possible, to keep an inventory of all operational and commercial inter-linkages between units and to identify systemically important activities .

- In the resolution phase, authorities must dispose of sufficient and appropriate powers to restructure institutions. As indicated, legal provisions to this avail are currently being put into place in many jurisdictions. It should be understood that, in this phase, holders of subordinated debt would have to "bail-in". A more difficult question is to what extent senior debt holders should also bear some burden at this stage. On the one hand, given the importance of senior unsecured debt for banks' re-financing, a substantial contribution could result either from converting part of senior debt into equity or from a hair-cut on or a restructuring of such debt. On the other hand, it is also evident that a "bailing-in" by senior creditors may lead to contagion in the rest of the financial system exactly the opposite of what we want to achieve through more effective resolution regimes. Moreover, if losses on senior debt are to be feared in the future, not only in cases of insolvency, but already in cases of resolution, investors will demand significantly higher returns - which would raise banks' re-financing costs. Such a regime could also cause investors to withdraw at the first sign of problems to avoid losses, which

would precipitate the decline of an ailing bank. All in all, it would seem to me that the issue needs to be explored much more extensively, before we can take decisions on this.
Let me also briefly mention here that I continue to believe that the existence of a bank resolution fund, funded by levies on the entire financial industry, can be helpful to facilitate an orderly winding-down. I therefore very much welcome the ideas the European Commission recently presented on this and hope that they will be pursued at the EU level.

- Finally, for the insolvency phase, we need to have effective insolvency procedures, also to cover crossborder institutions. Although this is obviously a hard nut to crack, I take comfort in the fact that this issue is firmly on the regulatory agenda.

5) Concluding remarks

Ladies and gentlemen, as this *tour d'horizon* on financial regulation has illustrated, the objective of making the global financial system more resilient requires a comprehensive effort. As the German philosopher Georg Christoph Lichtenberg once said: "I cannot say for sure whether things will get better when we change; but what I can say is they must change if they are to get better."
This probably sums up many peoples' feelings about the process of financial sector regulatory reform. While we all agree on the need for significant changes to the pre-crisis set-up, there is considerable uncertainty as to the new regime and the economic costs it entails. But I am confident that if we all continue to work with a shared sense of responsibility and with the commitment to the common good, the objective of a better financial system which is more resilient and at the same time still supportive to innovation and growth is within reach. Obviously, this is an objective that is worth every effort.

Thank you for your attention.