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Finding the right balance in regulation

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Thank you very much Josef. It is a pleasure to be here in Basel addressing this expert audience on such a challenging topic.

The title of this session is “finding the right balance in regulation”, but what do we have in mind when we raise this issue? In my view, the response is that we are talking about the risk of overregulation. And why are we talking about overregulation today? Well, it is obvious that we are facing a wave of regulation, as a response to the financial crisis. The risk now is of doing too much, rather than too little, in the area of regulation. But let me clarify that my remarks should not be seen as a criticism of the proposed G20 financial reform, be it Basel III or any of the other reforms. On the contrary, I am convinced that the proposals are the right response to the financial crisis: we are closing the loopholes that existed in Basel I and Basel II, we are not dealing with new problems, but rather with old problems that have come back to haunt us in an unexpected way, like liquidity and the issue of systemically important financial institutions (SIFIs).

I should be clear that I totally support what we are doing on Basel III. I have my own doubts about certain parts of Basel III, logically in the areas where we have been more, if you want, innovative. The purpose of my speech today is not to criticize Basel III. Rather it is a general reflection about what is the right balance of regulation. Because sometimes, I would not say particularly in the supervisory community, but in other spheres like the G20, there is the temptation to think that regulation is a silver bullet that can kill instability and correct the problems forever. But things are far from being that simple.

I am not going to try to define what overregulation is. I am going to deal with some of the aspects that overregulation implies. And before going into my comments I should stress once again that I will refer to Basel III in many areas. Yet again, this should not be seen as a criticism but rather as a reflection on what needs to be done to make Basel III an even more effective reform.

Regulation vs. Supervision

Let me deal with the first of the questions which is the trade-off between regulation and supervision. It seems that stronger, clearer rules, in particular the capital rules under Pillar I (including the leverage ratio that will migrate to Pillar I over time) could be seen as indicating that there is less need for a Pillar II supervisory review, or a supervisory action if you like. It is true that, by having more capital, and by having a better quality of capital, the tolerance to errors is greater, be these errors on the side of the banks or errors on the side of the supervisors. Let me focus on the latter. If we have stronger capital rules in Pillar I, we end up with a greater tolerance towards the mistakes of supervisors. Having said that, the idea that more regulation means you can have less supervision is deeply wrong. Regulation without supervision is useless. Regulation is always static. It is written and approved in a certain moment considering the situation prevailing in that environment: if you do not have supervision, you can forget about any regulation being effective. Or if you prefer, a regulation is only as good as its supervision, as its enforcement. In fact no one should be surprised by this concept because we have been able to see it in the recent crisis. Let me only mention one of the examples coming from the crisis: special purpose vehicles (SPVs).

IFRS required consolidation of those vehicles. That was clear in the rule. Did that happen? No. The rule wasn't generally implemented that way. Spain, in particular, required institutions to consolidate SPVs. In Spain, the Bank of Spain is the prudential regulator, but it is also the accounting regulator of the banking sector. In other countries it was the auditors who checked compliance with the rules. In the case of Spain, it was also the Bank of Spain. And you bet we read the rules and it was crystal clear that those entities had to be consolidated. And because they were consolidated, we did not have the SPV problem. (We had other problems but we can probably talk about them in another occasion).

So we have learnt during the crisis that having a good rule is not enough. You need to check that that rule is enforced. This may seem obvious, but it seems that not everyone is in exactly the same line, which worries me deeply because enforcement is crucial going forward. And not just enforcement but, probably, the coordination of that enforcement globally if we want to ensure we end up having not just the same rules but also the same interpretation and implementation of the rules.

Regulation versus risk management of banks

Let me go now to the second tradeoff: Regulation versus risk management of banks. Basel III means tougher rules, which is fine, and more intrusive rules, which is unavoidable: if you have tougher rules they tend to be more intrusive with respect to the way banks behave. But we should remind ourselves that there are limits to what we can do here.

The first message is that we do not run the banks. What's more, we do not know how to run the banks. I am a supervisor, I am a regulator. I am not a banker. I have no idea how to manage a bank. So we cannot think that we can substitute the bank managers. Our role is to regulate and supervise them; their role is to manage the bank in a way that is reasonable in terms of risks and rewards, in terms of profits. But we can never imagine that we can substitute the banks or the markets in that respect. That is not the role of regulation. Regulation should facilitate stability but should not try to replace bank management.

The second message goes along the same line: good risk management is crucial. But good risk management is useless without profitability. We need profitable banks, well managed from a risk perspective, but profitable. Imagine you have the best bank in terms of risk management practices, but that it is a lousy bank in making money. Would you be happy as a supervisor? No, you would be very worried. The combination we need to achieve is having banks with good risk management but also banks that can be profitable while controlling their risk in an adequate way. By the way, this idea does not come from Basel III. I was thinking about this when we had a meeting in Brussels on the European Commission proposals for corporate governance of banks and financial institutions. It is obvious that corporate governance was not adequate before the crisis and that board structures did not perform as they should have done in terms of controlling risks. But sometimes when I listen to the things we are requiring from bank board members, it seems to me as if we would like to have Basel Committee members on the boards. That is wrong. We are good at what we do, which is regulation and supervision. But what you need in the board of banks is people that can control the risks and continue to make money. What we need in the board of

banks is bankers and entrepreneurs, who know how to make money without incurring excessive risks. Entrepreneurship is as important as risk management in a bank.

A third element in this regulation versus management discussion is that we should be aware of the unintended consequences of what we are introducing. Something I like about Basel II is this idea of convergence between regulatory capital and economic capital. Why? Because it introduced the right incentives for banks in the area of risk management. A development that took place after Basel II was released and implemented in some countries is that chief risk officers were empowered in the banking organization. And this is important, because chief risk officers are our natural allies in the banks. They need our support to control the risks. And we should never forget that. Now, what is the concern? The concern is that Basel III increases the distance between economic capital and regulatory capital. Basel III, being more conservative than Basel II in many aspects, means that this convergence gets blurred, it disappears to some extent. This means that there are weaker incentives for better risk management by the banks because, since the regulatory threshold is so high, improvements in risk management may not be reflected in the performance of banks in the short run, and this fact can potentially weaken chief risk officers inside bank organizations. I think this is an aspect that we should try to avoid as much as possible. And we should be proactive in maintaining incentives for better risk management and in empowering chief risk officers in banking organizations, or, generally speaking, in any financial organization.

Regulation versus Market Discipline

Let me continue now with the balance between regulation and market discipline. We raised the bar and that means that the tolerance for errors is greater. But that again has a negative side effect that I do not like. I'm referring to the fact that bad managers will end up staying onboard. And that is not good. For sure, it is a difficult issue. On the one hand it is good to see the differentiation between good and bad managers in a crisis. There is nothing better than a crisis to discover who is a good manager and who the bad manager is. And there are also surprises. Bank managers that you thought that were going to be better, well they were lousy in the terms of risk selection. And you have other surprises, the positive ones, with respect to institutions you did not consider to be strong before the crisis. But if I can be frank, it may be very costly to discover who is a good banker and who is a bad banker. So the response here is not so easy, but my concern about the weaker market discipline which results from tougher regulation is still there. This is even more the case when we are talking about SIFIs. Here we risk creating ¨utilities like¨ institutions. I do not know if you are informed about the utilities sector but I cannot offer you a single example of a utility company going bankrupt or a utility sector manager being ousted due to poor performance. To minimize that risk we need to think about ways to impose market discipline on managers. And maybe the response is not so much in the solvency area, but rather we have to look at other areas of financial regulation. But we need to reinforce market discipline because we want good managers to stay and bad managers to go.

Regulation over the cycle

Let me now turn to the issue of regulation over the cycle. The financial system is procyclical. And supervisors and regulators are also procyclical. We are constructing Basel III in a weak economic environment. Why? Because the crisis facilitates the political and social support for the measures

that need to be approved, in order to reinforce the robustness of the financial system. This is, to some extent, unavoidable. But as supervisors we have to try, in the same way that we are asking banks, to be less procyclical than we currently are. Let me use for illustrative purposes the issue of dynamic provisioning in Spain. As a result of the frictions between IFRS and dynamic provisioning, we came under pressure to eliminate our reformed dynamic provision when we were adopting IFRS in 2004.. Since we were in a good economic environment, it was very difficult to resist the pressure. In the end we did not give in. And even though dynamic provisions are not a silver bullet, can you imagine what would have happened if we had given in to pressure in 2004? The lesson is that we regulators need to be countercyclical as well. We need to be tougher in good times.

Let me now take the opportunity to send a message I deem important. Basel III is a strong regime that incorporates buffers for capital and liquidity. My message is that we need to ensure that these buffers will be used in a crisis situation. I would be extremely worried if, when the time comes, we do not see buffers being used by banks, because of market fears or because of supervisors becoming nervous that buffers are running down. Buffers are there to be used and by no means can they be considered a new minimum. And if the buffers are not enough, then let's put higher buffers. To a certain extent, that does not worry me. As long as we guarantee that they are going to be used.

Let me finalize with another subject that is a favorite of mine, which is macroprudential regulation and microprudential regulation. They are both important and this is one of the lessons from the crisis. Before the crisis we were looking at individual firms without looking at the whole picture and how firms interact with each other in the market place. And we missed very relevant things. So the macroprudential view is extremely important. But let me issue two messages here. First, we cannot create a new category of global supervisors, the macro prudential supervisors. No, we are banking supervisors and we have to be both macro and micro. What we need is the micro prudential regulators to be aware of the macroprudential consequences of what they are doing. And second, macroprudential issues are very interesting, and intellectually appealing, but let´s be careful, let´s not get lost. If you ask me what macro prudential policy is, I would have a concrete answer: dynamic provisioning. It protected us when the crisis came. Not totally, that is for sure, but it protected the financial system as a whole. So all these macroprudential discussions will be good as long as we end up with something concrete that will help us in a crisis situation. Just having brainstorming sessions about macro prudential issues is not the right way to deal with macro prudential considerations.

Let me conclude now. It is difficult to define the optimal balance of regulation. Now, with Basel III, we have a stronger Pillar I, clearer, tougher rules, but if we want to make Basel III work, we had better ensure that we also have a stronger Pillar II and a stronger Pillar III. And please, no Basel IV until we all retire! Thank you very much!