AN EXCLUSIVE INTERVIEW

# Dombret Speaks

*An influential Bundesbank policy strategist offers his take on the IMF, hedge funds, the rating agencies, and the alleged design flaws in monetary union.*

**Andreas Dombret** *has been a member of the Executive Board of the Deutsche Bundesbank since 2010.*

**TIE:** **To what degree was the global financial crisis the result of Anglo-Saxon countries' lack of regulatory oversight and overconfidence in the efficiency of the market system?**

**Dombret:** With the benefit of hindsight, we might say that our belief in the efficiency of markets in the pre-crisis years was somewhat naïve, but it was accompanied by other misjudgments and economic policy errors. It is common knowledge that market transactions can only have efficient outcomes under certain conditions, which include well-aligned incentives, an absence of significant externalities, fully competitive markets, and so on.

What is therefore needed is a supplementary framework for legal and regulatory oversight that is continuously adjusted to innovations in the financial system. This was not adequately achieved for innovations in the originate-to-distribute model, where credit risk transfer into the shadow banking system turned out to be flawed, where risks were underpriced, where overall leverage in the system was too high, and where compensation schemes strongly rewarded short-term risktaking. Of course, internationally active banks domiciled outside the Anglo-Saxon world, including Germany, participated in this credit boom partly because they wanted to diversify their domestic exposures.

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***TIE:*** **Did developed world policymakers underestimate the problems resulting from the financial crisis?**

**Dombret:** What was widely underestimated was the scale of the damage following the initial "correction" in the U.S. housing market, the subprime mortgage market, and the more exotic segments of the structured credit markets. The collapse of leading financial institutions, rising unemployment, and increasing default risk for sovereigns went far beyond a cyclical process of "creative" destruction. There is no social consensus for this kind of economic volatility.

It is my impression that this experience has brought regulators in the United States, in the United Kingdom, and on the European continent closer together on many regulatory issues. For example, capital and liquidity standards as postulated by Basel I, and also in certain respects Basel II, are generally regarded as too lax now, and this has led to the development of stricter standards in different streams of regulatory reform.

***TIE:*** **What lessons can we learn from the experience of the last three years? What have policymakers learned about risk?**

**Dombret:** There is now also a global consensus that financial stability can be assured only if the financial system is viewed and treated as a whole. The crisis has painfully demonstrated that supervising individual financial institutions alone is not sufficient. This traditional microprudential perspective primarily aims at ensuring the stability and solvency of single entities. Yet it often fails to identify and adequately address systemic risks because it tends to neglect the interplay of individual market players and their interaction with the economy as a whole. This needs to change, and change is underway all over the globe—something you can really sense in all international forums.

*I don't agree with your suggestion that the EMU was badly designed.*

The new concept of macroprudential oversight takes a step back and tries to look at the forest instead of the trees. It aims at mitigating risks arising from contagion effects and the interaction of financial institutions, markets, market infrastructures, and the macroeconomy. We call this the cross-sectional dimension of systemic risk. In addition, macroprudential oversight pays attention to the time dimension of systemic risk by seeking to prevent financial imbalances from building up over time. As much as we will not be able to do away with the financial cycle, we are confident we can dampen it and so enhance financial stability.

***TIE:*** **How has the Bundesbank in particular changed its position toward financial risk?**

**Dombret:** In response to the crisis, national financial authorities and international institutions are now expanding financial supervision by establishing macroprudential oversight regimes or extending existing surveillance activities. Institutional frameworks are being set up and analytical toolkits are becoming more sophisticated. Central banks play a crucial role, both in national arrangements and at an international level. In the European Union, for example, we have recently established the European Systemic Risk Board. On this Board, central banks are key players. And I personally feel that that is a great leap forward. One of the ESRB's main objectives is to improve the understanding of how risks potentially interact and to recommend policy actions to counteract and mitigate such risks at an early stage.

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The Bundesbank also plays a central role in macroprudential oversight at the national level. We pay particular attention to macroprudential analysis and, since May 2009, the Bundesbank's newly created Financial Stability Department has been responsible for all of our work in this area. We have also intensified our research activities and involvement in scientific debates on financial stability. We liaise with the Federal Financial Supervisory Authority in a Joint Risk Committee. The idea behind this committee is to better link micro- and macroprudential knowledge and insights without blurring the boundaries between the institutions' individual areas of responsibility. In December 2010, the German government spelled out its intention to reform financial oversight. Although the details of this "ten-point plan" have yet to be clarified, one clear objective is to further expand the Bundesbank's macroprudential powers.

***TIE:* To what extent did shadow banking contribute to the financial crisis?**

**Dombret:** The crisis has clearly demonstrated that systemic risks can develop outside of the regular banking system, for example in mortgage brokers, finance companies, SPVs, money market mutual funds, and monoline insurers, to name but a few. This has therefore reinforced supervisors' and regulators' interest in all activities in the financial sector, particularly with regard to credit flows. Consequently, the G20 agreed to extend regulation and oversight to all systemically important financial institutions, instruments, and markets at their London Summit in April 2009. At the November 2010 Summit in Seoul, the G20 acknowledged significant progress in a number of areas and also identified some issues that warrant further attention, among others the oversight and potential further regulation of the shadow banking system.

Let me point out that "shadow banking" is not illegal and should not be criminalized. On the contrary, outsourcing of activities to specialized firms can be beneficial for the whole sector if these specialists can offer better services or terms while managing the risks appropriately. Nevertheless, risks within the shadow banking system can well become systemic. Moreover, banking regulation has become stricter in the aftermath of the crisis, increasing incentives to transfer activities to the shadow banking system. Such outsourcing must not allow these activities to evade the scope of oversight or undermine banking regulation. In our view, monitoring therefore needs to be broad in order to capture all areas where potential risks can arise, including financial innovations, and identify problematic developments early on.

***TIE:* So are the hedge funds the real culprit?**

**Dombret:** It is a truism that regulation has been broadened and deepened in many areas. In the European Union, the regulatory agenda for the financial sector is quite ambitious. It extends to those entities that belong to the shadow banking sector, such as hedge funds. As hedge funds were explicitly identified as a risk factor, one of the first EU regulatory undertakings in response to the G20 agenda was a new regulation for alternative investment fund managers. This new directive, passed in May 2011, can be seen as breaking new ground internationally. It establishes requirements governing the authorization and supervision of managers of hedge funds and other alternative investment funds. This is very important as the reporting obligations that the directive establishes for hedge funds afford insights into shadow banking. At the same time, they are also an important step in improving the statistical basis of macroprudential analysis.

I do not see any major "loose ends" for regulation at present. However, regulation is not, and in a dynamic financial system, can never be a one-off issue. New developments and financial innovations will require refinements. Moreover, as financial markets are global, more international harmonization of oversight and regulation would be an asset. This is not an easy task as legal definitions, even for banks, differ and as shadow banking comprises a very wide range of entities and activities.

***TIE:*** **Is the European Union doing enough to tackle the potential risks of derivatives?**

**Dombret:** It is important to keep in mind that derivatives, when used properly, play an important role in the efficient functioning of financial markets. But as the current crisis has shown, they can also lead to severe stress if regulation is insufficient. The G20 leaders therefore agreed to strengthen the resilience of these markets by enhancing transparency and market infrastructure. Within the European Union, there are several initiatives underway, always in compliance with the G20 recommendations, in particular the new European Markets Infrastructure Regulation and the amendment of the Markets in Financial Instruments Directive. I am convinced that the integrated regulatory approach of the European Commission in addressing the relevant issues, both from the trading and post-trading perspective, is a promising way to increase the transparency and resilience of the European derivatives markets.

With respect to large financial institutions, known as SIFIs (systemically important financial institutions), that are judged to be systemically important, the crisis has taught us one lesson: allowing these institutions to fail in a disorderly way would have a devastating impact on the financial system as a whole. This induces moral hazard for those institutions' risk appetite. Consequently, central banks and supervisory authorities are united in our overarching goal: SIFIs must be better regulated and more closely supervised, and they need specific capital buffers to guard against the systemic threat that they pose to the global financial system. Besides strengthening their resilience to shocks, incentives should be set to reduce their systemic importance over time. In a nutshell, SIFIs must no longer be allowed to pocket substantial earnings as a result of high risk-taking in good times while taxpayers have to cover heavy losses in times of stress.

***TIE:*** **Why is it taking so long to implement the high-level SIFI recommendations endorsed by the G20 at their last summit back in November 2010?**

**Dombret:** In international forums and working groups, we have been working hard on formulating these high-level SIFI recommendations. This is a matter of urgency. I fully support this initiative, including the agreement that we start by concentrating on global systemically

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important banks, also known as G-SIBs. Later on—as experience is gained—we intend to extend the framework in an appropriate form to other SIFIs, potentially including financial institutions of domestic relevance, financial market infrastructures, insurance companies, and other non-bank financial institutions.

The Financial Stability Board under the leadership of Mario Draghi is close to agreeing on important specifics of the future SIFI framework, and the Basel Committee on Banking Supervision has contributed a great deal. We have specified and provisionally agreed to a methodology for assessing systemic importance according to five broad categories, namely size, interconnectedness, lack of substitutability, global activity, and complexity. We have now also reached a general consensus on the amount and the components of additional capital requirements aimed at ensuring that the base of loss-absorbing capital is broad and high-quality. All of the representatives in the diverse working groups should be commended for having carried out such impressive work on highly complex issues within short time frames. The result is of course a compromise, which we at the Bundesbank fully support. In my view, the capital surcharge for SIFIs is a suitable means of putting a price tag on the implicit guarantee that SIFIs are considered to enjoy.

***TIE:*** **Will the current proposed reforms be adequate?**

**Dombret:** Most recently, the focus has been on the design features of viable resolution regimes for SIFIs in order to ensure that they can be wound up without dragging down the entire system and without using taxpayers' money. This poses difficult cross-border questions and is obviously a very tricky issue. It will ultimately take a strong commitment from G20 leaders to make winding-up a global SIFI a credible option, and this point is crucial. Unfortunately, in many countries general insolvency laws proved inadequate during the crisis. Progress is being made, however, at the G20 level. In Germany, the need for special instruments to restructure and resolve SIFIs has been met by the Restructuring Act, which entered into force at the beginning of this year. It envisions a significant extension of supervisory powers and the establishment of a restructuring fund, which will be financed through a levy from the banking sector. In this context, I'd like to stress that intervening in the institutional setup of a firm has to be weighed very carefully, as supervisory authorities should not replace a bank's management while the institution is still viable.

*This does not imply that the solution lies in a political union. A political union would not guarantee sound public finances.*

All in all, I'd like to emphasize that we should assess the risks posed by SIFIs and the corresponding policy measures as a "package." It is imperative to strike the right balance between stringent regulatory reforms and avoiding overregulation. It is very important to keep an overall view of the situation—not least since breaking up the policy suggestions into diverse parts gives leeway to immense lobbying by the financial industry within single jurisdictions and *vis-à-vis* the G20. This kind of lobbying has already started as anger about post-crisis bailouts seems to be fading while at the same time questions regarding banks' competitive position and their lending function to the economy gain ground. Let me be clear on this point: The international community needs to keep up the momentum for implementing the largest-ever reform package for the international financial system in order to safeguard financial stability to the greatest possible degree.

***TIE:* European policymakers have been frustrated with the credit rating agencies. Should these institutions be regulated or even outlawed?**

**Dombret:** The financial crisis has clearly demonstrated that mechanical reliance on the assessments of the credit rating agencies is not a promising way forward. Thus, in the interest of avoiding simultaneous selling when certain rating levels are reached and in the interest of fostering diversity in financial markets, we should not encourage market participants to take external ratings at face value. Instead, we must get the incentives right for them to undertake their own independent credit research. Regulating rating agencies—a path we have embarked upon on both sides of the Atlantic and beyond—may well contribute to more transparent and rigorous rating processes. Indeed, the Bundesbank welcomes the fact that the European Union already passed regulation for credit rating agencies in 2009, thus demonstrating that rapid decisions can be taken at the EU level despite the complex institutional setting. At the same time, the Bundesbank has continuously emphasized that regulation cannot solve the central issue of overreliance on ratings. And there is a related issue we are all familiar with: Over the years, policymakers and regulators have given external ratings a pivotal role by making reference to them in rules and regulations. Now, to put it bluntly, we are caught between a rock and a hard place.

***TIE:* What would replace the role of rating agencies?**

**Dombret:** One could try to argue that the new regulation in the United States based on the Dodd-Frank Act, and similar initiatives in the European Union, will sooner or later do away with these references. Unfortunately, though, intelligent replacements are not readily available for all the relevant areas. Take capital requirements for banks under the Basel regime: Would it make sense to hastily replace external "through-the-cycle" ratings with market indicators like bond spreads or CDSs? Probably not, as this would most likely reintroduce through the backdoor the very kind of procyclical tendencies in the financial system that we want to eliminate with new tools like counter-cyclical capital elements. It may therefore be more promising to take a step-by-step approach, allowing, for example, for the build-up of enhanced risk management capacities in parts of the financial industry. Here, the Bundesbank supports the Financial Stability Board's approach of coordinating the work of other regulatory bodies to reduce reliance on ratings in various pockets of the financial markets.

***TIE:* The IMF has increasingly taken on the role of an international rescue squad. Do you agree with this approach?**

**Dombret:** The IMF has a clearly defined mandate. In a nutshell, it is the Fund's task to promote the stability of the international monetary system. And it is surveillance which is the key tool for achieving this goal. In fact, the more effective and convincing Fund analysis and policy advice are, the fewer countries will need to turn to the Fund for financial assistance. I do not share the widespread view that high-volume financial assistance is an appropriate indicator of the IMF's relevance in the global economy. On the contrary, the provision of large-scale credit lines and standby arrangements without appropriate conditions attached can well distort incentives, provoke moral hazard behavior, and weaken countries' own efforts to pursue sound policies. In my view, "keeping their own house in order" continues to be the best contribution individual countries can make to preserving macroeconomic and financial stability.

***TIE:* So what should the IMF's role be if not as the new, and latest, global safety net?**

**Dombret:** All approaches to coping with future financial crises need to be designed so that they do not counteract effective prevention and maintain sound incentives. I am skeptical of the proposal to enable the IMF to offer member countries quasi-unlimited amounts of short-term liquidity with no strings attached. As the IMF is neither a world central bank nor a lender of last resort, it cannot and should not become a "hub" for central bank swap lines. In this context, it is important to remember that central banks have acted constructively and responsibly in providing large amounts of liquidity during the last crisis. Swap lines between central banks have proven to be an important tool for alleviating strains in banks' foreign currency liquidity. In those cases where central banks have been unable to extend swap lines, the IMF is well placed with its existing instruments to cover liquidity needs while staying within its resource envelope.

***TIE:* Isn't the ultimate reason for the European sovereign debt crisis the fact that the euro and the eurozone were poorly designed? With no political union, there is no way of enforcing fiscal rules. Moreover, without a political union going forward, why should the future be any less volatile than it is today? After all, all solutions seem to involve simply more debt and more public lending but with little accountability. Is the system as currently constructed sustainable?**

**Dombret:** The European Monetary Union consists of member states that share a single monetary policy but retain a large degree of autonomy and individual responsibility in fiscal and economic policy, a setup that is surely unique. However, I don't agree with your suggestion that the EMU was badly designed.

When the EMU was established, its founders recognized the risk of fiscal policy becoming its Achilles' heel. Fiscal rules were therefore established in order to maintain sound public finances. Unfortunately, the implementation of those fiscal rules over the first decade of the EMU was too lax. As a result, some member states' public finances were in a comparatively weak underlying position even before the financial crisis erupted. In addition, macroeconomic imbalances built up in some member states. They exploited the benefits of the EMU in terms of lower real interest rates in order to live beyond their means rather than promoting sustainable improvements in potential output. All in all, some member states failed to meet the requirements of a monetary union. When this became increasingly apparent in the course of the financial crisis, investors started to lose confidence in the peripheral countries' ability to repay their debts. Interest rate spreads, unusually low before the crisis, then quickly widened to record levels.

It is true that lessons have to be drawn from this experience, but this does not imply that the solution lies in a political union. Even if we leave aside the fact that the public's appetite for deeper European integration appears to be quite limited and likely to remain so for the foreseeable future, a political union would not guarantee sound public finances. Rather, we should strengthen the existing framework to improve crisis prevention and crisis resolution.

Such efforts are already underway, even though admittedly the verdict on the reforms of the euro area's economic governance, which have yet to be finalized, is mixed. Strengthening prevention is a step in the right direction, but the approach remains too timid, particularly concerning the Stability and Growth Pact. Ultimately, however, the effectiveness of both the strengthened fiscal rules and the newly established macroeconomic surveillance will crucially hinge on the political will of the governments to strictly apply the rules. As regards crisis resolution, the European Stabilization Mechanism must remain the last resort in cases of risk to the financial stability of the euro area as a whole. Assistance must only be granted with strict conditionality, and in the event of a solvency crisis, the first step in restoring sustainability should be some sort of private-sector involvement. Letting investors bear the risk of their investment decisions is key to reestablishing the disciplining effect of financial markets on fiscal policy as a complement to stricter rules for crisis prevention. This has to be our aim. ◆