Andreas Dombret: Business models and the banking sector seen in terms of financial stability

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 16th Banking Symposium of the European Center for Financial Services "Profile and profitability – are banks' business models in transition?", Düsseldorf, 20 September 2012.

* * *

1. Introduction

Professor Rolfes

Ladies and Gentlemen

No question: the causes of the financial crisis are manifold. How they all fit together is currently not yet fully known. Perhaps this can never be fully explained – not by practitioners and academics. However, they might be able to achieve an improved understanding of how some of the individual parts interact.

This is one of the aims of a symposium like this one, in which practitioners and academics can convene and communicate with one another. This is also why I was very glad to accept your invitation, for which I thank you very much.

I would like today to address the distinctly interesting individual elements of the build-up of risk and some elements of the associated financial innovations – key components of a bank's business model. If a business model can be regarded as a bank's genetic code, the business models of banks and intermediaries make up the DNA of the financial system.

This not just interesting for its own sake. In fact, it is a vital aid in better understanding another debate: that on universal banking systems and specialised banking systems.

2. From unsustainable business models to the financial crisis

In key areas in the financial system, several banks' business models were undergoing a change best described as a departure from traditional commercial banking. What essentially lay behind this? Why was it able to pose such a severe threat to financial stability?

Few models have provided as much information in the search for an answer to these questions as that in the seminal work by University of Chicago economist Douglas Diamond. Its bears the somewhat non-descript title "Financial Intermediation and Delegated Monitoring". And his seemingly more innocuous question is, why do financial intermediaries exist? Put another way: What can intermediaries do better than the markets? And then the question no longer sounds as innocent.

Diamond presumes major information asymmetry between creditors and debtors. Only the entrepreneur can freely observe his investment project. Potential lenders have a choice between costly monitoring of the investment project or setting incentives to comply with the contract. If a borrower only stands to lose his house, as was the case with US subprime borrowers, the incentives are quite flawed, indeed.

If a bank monitors the status of investment projects, diversification and economies of scale can be achieved. By financing multiple projects simultaneously and monitoring them over a relatively long period of time, banks can reduce their monitoring costs. By contrast, monitoring individual projects is inefficient. This explains the existence of banks – and of intermediaries. And it is probably also for this reason – at least as seen from the assets side – that commercial banking is a wholesale bank's "natural" business model.

Through credit substitution business, many banks have departed from this model; have surrendered much of the inherent, comparative (says Diamond) advantages of their intermediary function; have left credit assessments to rating agencies; and have, in some cases, delegated monitoring. At the same time, when packaging loans and in lending contracts, they looked not at appropriate incentive structures but, above all, at tradability. If it can be traded, the risk can then be fobbed off on a third party – or, at least, that is how the thinking goes. In effect, securitisation techniques dissolved the link between oversight and the ultimate bearer of risk.

The advantages of intermediation were forsaken without creating sustainable contractual solutions at the same time. Even in theory, there was no way that could work. As Warren Buffett famously put it, "It's only when the tide goes out that you learn who's been swimming naked."

From that angle, the oft-cited deficiencies in some banks' risk management practices are not an accident, but instead, seen in that light, the logical outcome of the departure from the traditional business model. In this middle world between intermediation and the market, in which neither worked, there were simply not enough incentives to mitigate risk.

Please do not misunderstand me: I firmly believe that those innovations which have created real economic value added will survive in the long term. But that will probably be on a reduced scale, in less complex and more transparent structures, and embedded in supervisory practice. If used prudently and monitored carefully, they can enhance the performance of the financial system without jeopardising financial stability.

Another thing should not be overlooked: not every transaction that generates commission income is a complex securitisation. A savings bank or cooperative bank can successfully diversify its earnings side by selling Riester retirement products. It is less dependent on maturity transformation and swings in interest rates. Who could possibly object to that? In and of itself, this is good for financial stability.

And not every trading transaction with modern financial products is driven by the search for maximum yields in proprietary trading. If a bank closes a currency hedge deal for a customer who is active in international trade, this has a sound real economic basis. In that case, investment banking serves the customer's interests. Nobody can really have object to that, either. A bank whose business model is targeted at export-oriented customers will have to provide this kind of service, otherwise its business model will not work. And it will obtain commission income that should be in reasonable proportion to the services rendered. The same is also true, for example, of M&A consultancy services.

However, the non-interest earnings components are generally more volatile, especially if generated by proprietary trading in complex investment banking products. Such earnings components evaporate quickly in a crisis and can put a strain on profitability. This is shown by many empirical studies.

We therefore have to assess the relationship between profitability and resistance differently than in the pre-crisis era. Back then, there were many – but not among supervisors or academics – who believed that there was a one-to-one relationship between profit and risk. We now know this: sustainability is what counts. And sustainability cannot exist in an environment of very high volatility.

Those who desire more sustainable profitability and business models have to put stricter limits on proprietary trading. The Basel III rules governing market risk serve this objective and, in my opinion, point in the right direction. They are set up to reduce the volatility of profitability.

Volatility, the close interrelationships with other players in the financial system and the high financial leverage are all reasons for the systemic importance of investment banks.

On the liability side, too, quite a few institutions departed from the commercial banking model. The significance of market-based funding instruments has increased enormously, while the role of customer deposits has shrunk. This has increased banks' dependency on market-based funding and made such funding more vulnerable to market pricing and market movements. And this has been accompanied by a tendency towards short-term funding.

This should actually lead to an increase in interest rate risk and liquidity risk. However, empirical studies by the Bundesbank show that the major systemically important banks – at least in Germany – largely shield themselves from interest rate risk. On balance, they have hedged a large percentage of their positions. Interest income risk is therefore not affected.

However, there is still liquidity risk – in other words, refinancing risk. This was seen by many as irrelevant during the boom cycle. Market liquidity dried out quickly during the financial crisis, though. It became ever-more difficult to roll over loans, even though central banks were doing all they could to help.

It used to be true that "liquidity followed creditworthiness" or that "liquidity followed solvency". The financial crisis has shown that this is not the case all the time. Even institutions with a "healthy" asset portfolio were capable of running into distress – not least because, at first, nobody was entirely sure who was holding how much in "toxic assets" on their balance sheets – and also, and especially, off their balance sheets in the "shadow banking system". Spun-off SPVs meant that now everyone was a suspect.

3. Specialised banking versus universal banks: missing the point

One of the main concerns in the aftermath of the crisis has been making the banking system safer overall and protecting taxpayers, and thus the general public, from having to pay the price for banks' mistakes – and quite rightly so.

Some observers who are "in the know" believe that divorcing investment banking from commercial banking is the perfect way to limit the social costs of ailing banks. A high-level Expert Group of the European Commission, headed by Erkki Liikanen, Governor of the Bank of Finland, is studying these issues. I therefore now only want to go into some aspects which I think are particularly important.

As I said at the beginning, investment banking does, indeed, involve very specific risks. By contrast, traditional banking, with its deposit and lending business, is often – but not necessarily always – characterised by a less risky business model. Some argue that separating the two types of banking activities would protect the macroeconomically vital task of supplying the real economy with credit and, at the same time, shielding it from investment banking's inherent risks. They also claim that this would make bank resolution easier.

What I'm wondering, however, is if such a specialised banking system can truly fulfil all the hopes invested in it. Unfortunately, in practice it is not always possible simply to put the good ones into the pot and the bad ones into the crop, to paraphrase the Grimm Brothers.

For one thing, we cannot ignore the problems of where to draw the line and how to put this into practice. In particular with regard to corporate services, it is not quite that easy to make a clear distinction between traditional banking services and investment banking services. And, problems in drawing a clear boundary generally result in loopholes.

In terms of financial stability, however, a much more serious issue is at stake. One of the proposals for a specialised banking system currently on the table – the Vickers blueprint – would distinctly reduce interlinkages, which is welcome as far as its effects on financial stability are concerned. However, that would probably not close off every possible contagion channel. Banks are interlinked through all sorts of other channels. Not least, during the financial crisis, in order to prevent contagion, in particular, governments also gave support and assistance to many investment banks or – as I would call them – quasi-investment banks.

The Lehman Brothers bankruptcy caused precisely such contagion, but not because customer deposits were at risk. Rather, it had many connections to other financial institutions including, and above all, as counterparty in derivative transactions, in which Lehman Brothers was particularly heavily exposed. Essentially the same applied to AIG – which was not even a bank, but an insurer. AIG was also a major counterparty. In this case, too, the government rescue package was intended to keep further shock waves from buffeting the financial system. And in the case of the largest rescue operation in Germany, that to save Hypo Real Estate, customer deposits were not the main issue, either, but rather the danger of wide-ranging domino effects – on other banks; on the Pfandbrief market, for which the affected institution was a major issuer; and for insurers, for whom Pfandbriefe are key investments.

Not everything is rosy even in classical banking business. The very large banks – those deemed "too big to fail" – are not the sole sources of systemic risk. The Spanish case has made this abundantly clear. Here, banks were destabilised by their exposure to the real-estate market. These vulnerabilities were created in traditional lending business.

Proponents of specialised banking systems believe this will produce a better solution to the "too big to fail" problem. And, the wisdom of introducing a system of specialised banks has to be judged in terms of whether it makes it easier to supervise large, complex financial institutions. Even more important, as I see it, is whether such banks can, in a crisis, be more easily resolved if they do not have an investment banking arm. After all, a break-up leads to the creation of smaller banks.

This much I believe: the best regulatory solution for the "too big to fail" problem is the credible threat of an institution's orderly market exit. This is well within the tradition of standard insolvency law, if you will. And in cases where standard insolvency or bankruptcy proceedings cannot be applied precisely because of this "too big to fail" problem, other resolution regimes – and credible regimes at that – are needed. Developing cross-border, harmonised resolution regimes is therefore also at the core of international reform efforts.

Shareholders and creditors of distressed banks are to bear the losses, wherever possible, without passing them on to taxpayers and without posing a threat to financial stability. In a crisis, it should be possible to transfer an institution's critical functions to third parties or government bridge banks – even without the prior consent of the institution, shareholders or creditors. These critical functions have to be maintained; otherwise financial stability would be at risk.

The decisive factor – as always when it comes to money and finances – is credibility. Is it possible to introduce a credible resolution regime with the existing structures? Or are these structures too complex for a realistic market exit? The TBTF problem desperately requires a solution. If a solution can be found through credible resolution regimes, the advantages of universal banking do not need to be sacrificed. Let me repeat: credible resolution systems are the much better option for regulatory purposes.

I do see where the proponents of specialised banking are coming from. However, do not be fooled: simply ring-fencing investment banking from banks' core business will not be enough to prevent future systemic crises.

We therefore need to focus more strongly on the underlying sources of systemic risk in banks' business models and then effectively mitigate them.

This will involve subjecting activities such as banks' proprietary trading to critical examination. As it is difficult to draw a clear line, it would be better for us, here, to focus less on whether or not to permit its very existence and more on capital adequacy.

I am fully in agreement with Mr Schmitz, President of the Association of German banks, when he says that "the decisive factor is that the risk incurred is commensurate with risk buffers. *To that extent, imposing greater restrictions on some areas of proprietary trading than existed before the crisis makes sense and is the right move."*

4. Capital adequacy: a key element

Solvency is a necessary, but not sufficient condition for financial stability. What is crucial for solvency, besides the quality of the asset portfolio, is the amount of capital. This is a key element in restoring confidence.

That is just as relevant now as it was in 2008 and 2009. In its 2011 *Financial Stability Review*, for example, the Bundesbank had the following to say, *"However, in times of systemic stress, markets cease to make broad-based distinctions because, supposing an exogenous shock actually triggers a systemic crisis, it is almost impossible* ex ante *to forecast the position of an individual bank. In such a scenario, the task of restoring confidence is not merely the responsibility of an individual bank but also a call to arms for the system as a whole."*

Injections of capital can be one weapon in that cause. Capital adequacy is not everything. But without adequate capital, it all comes to nothing.

Capital acts as a substantial internal buffer. Such buffers have to be large enough to cushion any stresses and strains. Provided they are put in place in good time, lending does not have to be cut back straightaway, even in the event of a systemic shock. The institutions gain some respite and do not have to launch fire-sale auctions to shed their risky assets all at the same time, which can bring about a cumulative decline in the value of those assets.

Here I can see many practitioners objecting on the grounds that capital is too scarce and expensive. Most economists doubt that or – like the Bonn economist, Martin Hellwig – they do not accept it as a reason for forgoing stricter regulatory capital requirements.

The reason is that, at this point, practitioners like to argue implicitly using a *ceteris paribus* clause, in other words, all other things being equal. In this line of reasoning, the capital donors have a certain idea about the return on the capital they have put in. If the capital share is increased, expenditures are greater than in a situation with higher borrowed capital.

The crux of the matter is this: all other things are not equal. That is because the required return on capital contains a risk premium. This compensates the shareholders for the entrepreneurial risk. And the risk premium falls if the capital is increased, which means that the entrepreneurial risk is spread over more capital. Under certain assumptions, it is even possible to show by how much the risk premium is reduced: and that is by precisely the amount that the overall capital costs remain unchanged. This is the substance of the Modigliani-Miller theorems.

And to anyone saying this is nothing but dry theory and that everything is quite different in investment banking practice, I would reply that this can be proved by precisely the same means used in investment banking for valuing options. And even if complete neutrality of financing is not guaranteed, there is no way round the fact that the risk premium and the required return on capital have to go down if the capital share goes up. It is simply a matter of economic logic. That fact alone puts the notion of "expensive capital" into some sort of perspective.

The neutrality of funds applies as long as there are no distortions which affect the two types of capital differently. Even so, outside capital is given preferential tax treatment over equity capital by way of the tax deductibility of interest payments. Tax breaks for servicing debt thus lower the costs of borrowed capital.

And what is perhaps even more significant: during the financial crisis, explicit and implicit guarantees for systemically important institutions meant that borrowing was, eventually, being subsidised. From the point of view of a big bank, loan capital becomes cheaper than equity capital. Is the practitioners' view that equity capital leads to higher costs is therefore right in this context after all? No, because the implicit guarantee on loan capital means that, in the event of a crisis, the costs are transferred to the general public or, in other words, the taxpayer. This results in a disconnect between microeconomic and macroeconomic costs and benefits, as was pointed out by the German Council of Economic Experts.

There was fallout from this, of course. It set the wrong incentives. It favoured highly leveraged business models. It gave an excessive stimulus to risk-taking. In short, it created moral hazard. Thus, if a higher input of borrowed capital was or is cheaper for the bank, this was only because the costs of this were or are payable elsewhere. Conversely, the business costs of higher capital requirements are offset by relief elsewhere, namely for the taxpayer – quite apart from the stabilising effects which larger capital buffers have for financial stability.

From a microeconomic perspective, one can, of course, well understand that there is resistance to higher capital requirements. That does not mean that such resistance is justified in macroeconomic terms, far from it.

Or, as Mr Hellwig put it, "*Given these negative externalities from banks using debt rather than equity, there is no reason to refrain from requiring banks to have more capital on the grounds that equity is expensive and the regulation would raise bank's cost of capital. Quite the contrary, such a regulation would merely counteract the perverse incentives that are created by the corporate tax system and by the inability of government to commit to not bailing out banks."*

5. Conclusion

Allow me to summarise my thoughts as four basic propositions.

First: the business models of a number of banks underwent a fundamental transformation associated with turning away from traditional business towards investment banking.

Second: this meant that profitability was subject to a high degree of volatility.

Third: if we solve the "too big to fail" problem, there will then be no reason to forgo the advantages of universal banks.

Fourth: adequate capital is a key element in achieving financial stability.

These propositions might not cover everything, but I see them as vital elements. If these lessons are applied in the reform efforts, we shall already have achieved a great deal. I, at least, shall do my utmost to make this happen.